OFFICE OF THE

CITY AUDITOR

AN AUDIT OF THE CITY OF SAN JOSE RETIREMENT PLANS' INVESTMENT PROGRAM

- OPPORTUNITIES EXIST TO INCREASE RETIREMENT FUND EARNINGS AND REDUCE INVESTMENT COSTS BY (1) ENFORCING PERFORMANCE OBJECTIVES ON INVESTMENT MANAGERS, (2) INCREASING USE OF PERFORMANCE-BASED FEES, (3) REDUCING THE NUMBER OF INVESTMENT MANAGERS, AND (4) INCREASING USE OF INDEX FUNDS

- OPPORTUNITIES EXIST TO ENHANCE THE RETIREMENT BOARDS' ABILITY TO ASSESS THE STATUS OF THE INVESTMENT PORTFOLIOS

- CHARGING THE RETIREMENT PLANS FOR SERVICES THE FINANCE DEPARTMENT PROVIDES WOULD REDUCE GENERAL FUND EXPENDITURES BY $61,000 PER YEAR AND POOLED INVESTMENT FUND EXPENSES BY $11,000 PER YEAR

A REPORT TO THE

SAN JOSE

CITY COUNCIL

AUGUST 1995 95-04

9600497

GERALD A. SILVA
City Auditor

CITY OF SAN JOSÉ, CALIFORNIA

151 W. MISSION STREET, ROOM 109
SAN JOSE, CALIFORNIA 95110
(408) 277-4601

August 18, 1995

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose CA 95110

Transmitted herewith is a report on *An Audit of the City of San Jose's Retirement Plans' Investment Program*. This report is in accordance with City Charter Section 805.

An Executive Summary is presented on the blue pages in the front of this report while a Retirement Office response is shown on the yellow pages before the Appendices.

In addition, we have included some comments on the Retirement Office's response. These comments are on the green pages immediately following the Retirement Office's response.

I will present this report to the Finance Committee at its August 23, 1995, meeting. If you need additional information in the interim, please let me know. The City Auditor's staff member who participated in the preparation of this report is Sharon Erickson.

Sincerely,

Gerald A. Silva

Gerald A. Silva
City Auditor

GS:ls

cc: Regina Williams
Debra Figone
John Guthrie
Larry Lisenbee
Joan Gallo
Sherry Langbein
Jessica Batinich
Ed Overton
Tony Cokely
Bradley Inamura
Zeke Garcia
Paul Wysocki
David Bacigalupi
Richard Santos

OFFICE OF THE

CITY AUDITOR

AN AUDIT OF THE
CITY OF SAN JOSE
RETIREMENT PLANS' INVESTMENT PROGRAM

A REPORT TO THE

SAN JOSE

CITY COUNCIL

TABLE OF CONTENTS

LIST OF TABLES

LIST OF CHART AND GRAPHS

EXECUTIVE SUMMARY

In accordance with the City Auditor's 1994-95 Audit Workplan, we have audited the investment programs of the city of San Jose's (City) retirement plans. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the staff of the Retirement Program for its time, insight, and cooperation during this audit.

OPPORTUNITIES EXIST TO INCREASE RETIREMENT FUND EARNINGS AND REDUCE INVESTMENT COSTS BY (1) ENFORCING PERFORMANCE OBJECTIVES ON INVESTMENT MANAGERS, (2) INCREASING USE OF PERFORMANCE-BASED FEES, (3) REDUCING THE NUMBER OF INVESTMENT MANAGERS, AND (4) INCREASING USE OF INDEX FUNDS

The Federated City Employees' Retirement System's (Federated Plan) and the Police and Fire Department Retirement Plan's (Police and Fire Plan) investment portfolios are composed of fixed income securities (bonds), equities (stocks), and real estate. The two plans use 24 external investment management firms to manage the $1.4 billion portfolio. Over the past ten years, the plans' bond managers generally outperformed the market indexes. However, over that same period, the two plans have engaged 21 different outside equity managers who have cumulatively performed below equity industry benchmarks. Our review revealed that

- The majority of investment managers have underperformed the performance objectives outlined in the retirement funds' investment policies;
- The retirement plans do not have a formal probationary process for investment managers;
- Investment manager contracts do not specify management style, performance standards, or probationary processes;
- Eight of the investment management firms were founded less than ten years ago;
- Only one manager is paid a performance-based fee; and
- The large number of investment managers increases costs and imposes a burden on Retirement Program staff.

Finally, most public pension plans have a larger portion of their equity portfolios invested in equity indexes. For example, the California State Public Employees' Retirement System has 80 percent of its equity portfolio invested in an equity index. In contrast, the City's retirement plans have only 5 to 6 percent of their domestic equity portfolios invested with index managers. If the retirement plans' equity portfolios had been invested in an equity index fund instead of with the variety of managers that were used, we estimate that the portfolios could have earned an additional $72.8 million over the last ten years and saved about $10 million in management fees paid to equity managers. These additional earnings and fee savings would have improved upon the funded status of both retirement plans as of June 30, 1993. Further, we estimate the retirement funds may be able to earn up to $7.1 million a year more if they index their equity portfolios. In addition, investment management fees could be reduced by up to $1.9 million annually. Accordingly, the boards of administration for the retirement plans should increase the use of equity index funds. In addition, the

boards should establish formal probationary processes for investment managers whose performance falls below applicable standards, increase use of performance-based fees, and reduce the number of investment managers.

OPPORTUNITIES EXIST TO ENHANCE THE RETIREMENT BOARDS' ABILITY TO ASSESS THE STATUS OF THE INVESTMENT PORTFOLIOS

The San Jose Municipal Code requires monthly reporting of short- and long-term retirement fund investments. However, our review revealed that the funds' monthly investment reports are not issued in a timely manner and that millions of dollars in short-term retirement fund investments are not included in the monthly investment transaction resolutions. Moreover, in spite of the fact that asset allocation decisions determine investment performance and have potential multi-million-dollar effects on investment earnings, the Federated Plan's and the Police and Fire Plan's asset allocations and investment policies were not comprehensively reviewed for several years. In our opinion, the respective boards of administration should improve the timeliness and completeness of reporting on the status of the investment portfolios and establish procedures to annually review investment policies and asset allocation strategies.

CHARGING THE RETIREMENT PLANS FOR SERVICES THE FINANCE DEPARTMENT PROVIDES WOULD REDUCE GENERAL FUND EXPENDITURES BY $61,000 PER YEAR AND POOLED INVESTMENT FUND EXPENSES BY $11,000 PER YEAR

The Finance Department provides certain unreimbursed accounting services to the retirement funds. The General Fund and the Pooled Investment Funds absorb the cost of these activities. By charging the retirement plans for

these costs, the General Fund would save about $61,000 per year and the Pooled Investment Funds would save about $11,000 per year.

RECOMMENDATIONS

We recommend that the Federated Employees' Retirement System and the Police and Fire Department Retirement Plan:

Recommendation #1:

Establish probationary procedures including:

- A process for placement on a formal watch list and subsequent probation when a manager's performance falls below applicable standards and
- Procedures for reporting underperformance of investment manager benchmarks on a quarterly and annual basis that call attention to managers that are not in compliance with investment performance objectives.

(Priority 2)

Recommendation #2:

Revise the standard language in investment manager, advisor, and/or custodian bank contracts to include (1) benchmark performance standards, (2) a process for dealing with underperformance, (3) timeliness requirements for reporting, and (4) reference to the City Council's Policy #0-15 (the code of ethics). (Priority 2)

Recommendation #3:

Review the experience qualifications that are specified in the San Jose Municipal Code for investment managers and either propose changes to the Code or ensure that investment managers are in compliance. (Priority 2)

Recommendation #4:

Negotiate performance-based fee structures as investment manager contracts become due. (Priority 2)

Recommendation #5:

Reduce the number of investment managers and decrease investment fees by

- Increasing use of index funds;
- Avoiding duplicative management styles; and
- Pooling investments in certain asset classes between the two retirement funds.

(Priority 1)

Recommendation #6:

Establish a phased program to transfer substantial portions of the domestic equity portfolios of the two retirement plans to index managers. (Priority 1)

Further, we recommend that the Retirement Program:

Recommendation #7:

Prepare monthly investment reports similar in scope to the Finance Department's Monthly Investment Report. The executive summary should

include significant developments; market overview; portfolio mix and yields; exceptions and violations of the investment policy; description of unrealized losses and gains; comparison to budget; and future commitments and cash management projections. (Priority 2)

Recommendation #8:

Clarify and enforce custodian bank timeliness requirements for reporting. (Priority 2)

In addition, we recommend that the boards of administration for the retirement plans:

Recommendation #9:

Establish a process to annually review their asset allocation strategies. This review should include a comparison to other public pension funds. (Priority 1)

Recommendation #10:

Establish internal investment committees to advise the boards of administration of the retirement plans on asset allocation strategies and investment policy changes. The committees should include retirement staff, private and public sector investment experts, and City Finance Department/ Administration representatives. (Priority 2)

Recommendation #11:

Establish a process to annually review the investment policies for the respective retirement funds and distribute updated copies of the policies to investment managers and advisors annually. (Priority 2)

Recommendation #12:

The Federated Employees' Retirement System's board should include a liquidity statement in its investment policy. Both boards should establish procedures requiring an annual review of their cash flow requirements. (Priority 2)

Also, we recommend that the City Attorney:

Recommendation #13:

Draft an amendment to the San Jose Municipal Code for City Council approval to delete references to the City Auditor in Municipal Code section 3.36.520 regarding warrants drawn on the Police and Fire Retirement Fund. (Priority 3)

Finally, we recommend that the Budget Office:

Recommendation #14:

Prepare an estimate of City expenses attributable to the Retirement Program and allocate those expenses to the retirement funds. (Priority 1)

INTRODUCTION

In accordance with the City Auditor's 1994-95 Audit Workplan, we have audited the investment programs of the city of San Jose's retirement plans. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the staff of the Retirement Program for its time, insight, and cooperation during this audit.

SCOPE AND METHODOLOGY

Our audit focused on the performance of the investment programs of the Police and Fire Department Retirement Plan and the Federated Employees' Retirement System. We evaluated the performance of the two plans' investment portfolios and investment managers. We compared the plans' asset allocation strategies and investment policies with other public retirement plans. We also compared the plans' portfolio yields with industry benchmarks. In addition, we reviewed the fee structures of the various investment management firms (investment managers), assessed investment manager contracts' completeness, and assessed the adequacy of financial reporting to the boards of administration for the retirement plans and the City Council.

BACKGROUND

City Charter And Municipal Code

The San Jose City Charter authorizes the City Council to establish retirement plans for city of San Jose (City) employees. The boards of administration administer the plans, set contribution rates, obtain actuarial studies, and act as stewards over fund assets. The Retirement Program (Retirement) administers the retirement plans.

The San Jose Municipal Code includes a series of chapters related to the various retirement plans in effect through the years including Chapter 3.16 (effective prior to October 1946), Chapter 3.20 (effective October 1941), Chapter 3.24 (effective July 1951), and Chapter 3.32 (effective 1946). The two current retirement plans are the 1975 Federated Employees' Retirement Plan (Chapter 3.28, effective July 1, 1975) and the 1961 Police and Fire Department Retirement Plan (Chapter 3.36, effective February 1, 1962). Table 1 summarizes the provisions of the two retirement plans.

TABLE 1

COMPARISON OF RETIREMENT PLANS, BENEFITS, AND ACTUARIAL ASSUMPTIONS

	FEDERATED PLAN	POLICE AND FIRE PLAN
Board members	• Tony Cokely, Chair • Zeke Garcia, Civil Service • Frank Fiscalini, City Council • Bradley Inamura, Employee • William Bascom, Bank Representative	• Paul Wysocki, Chair • David Bacigalupi, Police Department • George Shirakawa, Jr., City Council • Charlotte Powers, City Council • Richard Santos, Fire Department
Final compensation	36 highest months	12 highest months or 108% of last 12 months
Service retirement qualifications	30 years service OR 55 years old with 5 years service	30 years service OR 55 years old with 20 years service OR 50 years old with 25 years service OR 50 to 55 years old with 20 years service (pro-rated by age at retirement)
Retirement annuity (service retirement)	Final average salary multiplied by 2.5% per year of service (75% maximum)	Final compensation multiplied by 2.5% per year of service (75% maximum)
Service-connected disability retirement	Final average salary multiplied by 2.5% per year of service, subject to 40% minimum and 75% maximum; less outside earnings in excess of 100% of final compensation until age 55	50% of final compensation plus 2.5% for each year of service over 20 years (less outside earnings in excess of 100% of final compensation until 20 years is reached)
Nonservice-connected disability retirement	5 years service (vested employee)--final average salary multiplied by 2.5% per year of service (subject to 40% minimum and 75% maximum); less 0.5% for each year under age 55; less outside earnings in excess of 100% of final compensation until age 55	2 to 20 years of service--32% of final compensation plus 1% of final compensation for each year in excess of 2 (75% maximum); OR 20 or more years service--final compensation multiplied by 2.5% per year (75% maximum)
Contributions	As of July 1994: City 18.01% plus employee 8.12%; previous rates were 15.59% and 6.88%	City 22.24% plus employee 9.36% (interest credit of 2%); previous rates were 22.99% and 9.42%
Medical benefits	15 years	15 years
COLA	April 1 (not more than 3% or banked)	April 1 (not more than 3% or banked)
Vesting	5 years	10 years
Service credit	1,739 maximum hours per year	2,080 maximum hours per year

PERS Reciprocity

The City entered into reciprocity agreements with the California Public Employees' Retirement System (PERS) in August 1994. The main feature of reciprocity is portable retirement benefits so an individual can work for a number of public employers without losing benefits. Neither retirement plan has adjusted contribution rates to pre-fund the program. The latest actuarial report to the board of administration of the Federated Employees' Retirement System (Federated Plan) estimated the pre-funded cost of reciprocity at around 0.5 percent of pay. Assuming a Federated Plan employee payroll of $141 million, the costs could be in the range of $700,000 annually.

Department Organization And Functions

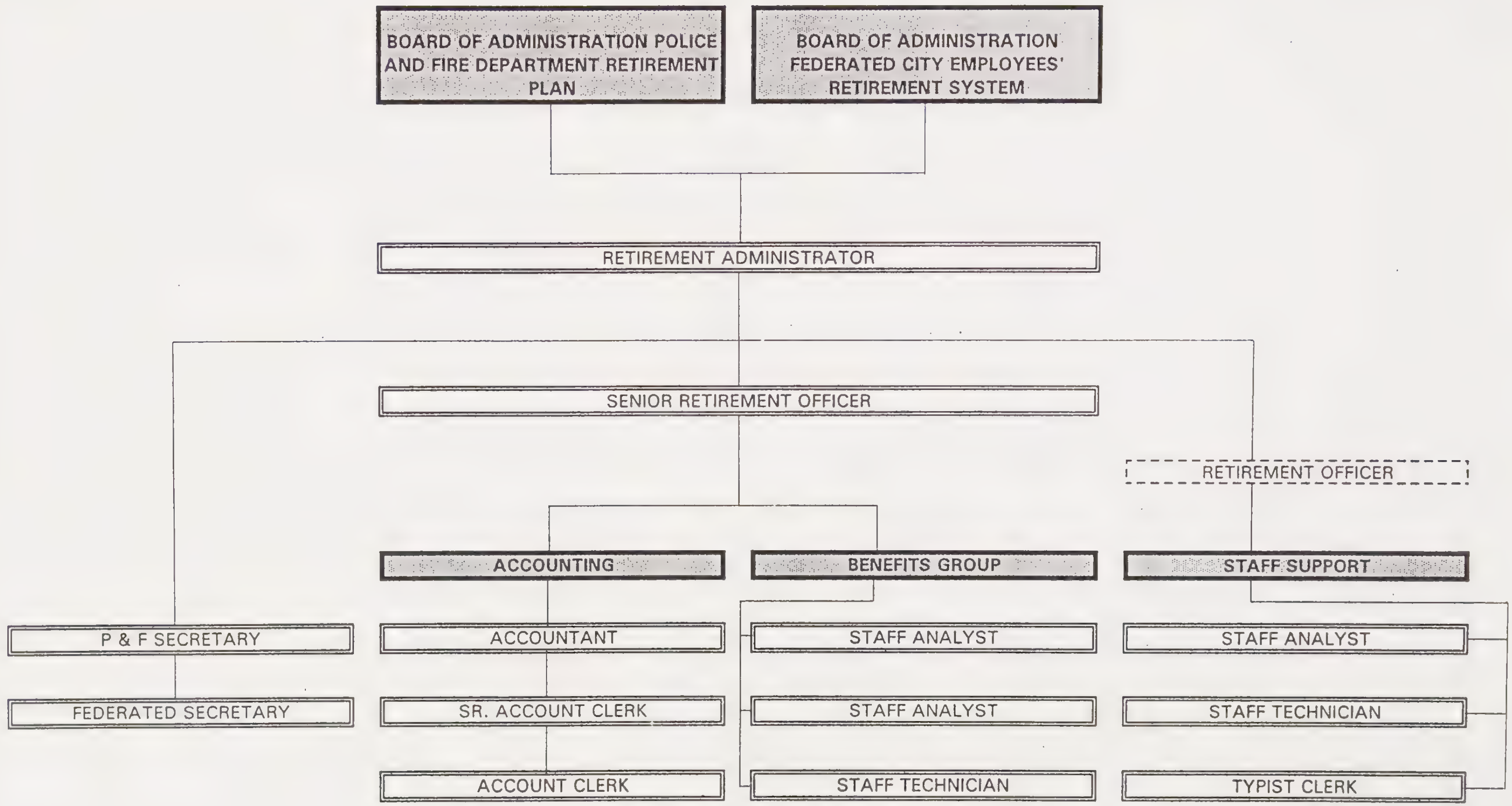
The Retirement Program administers the City's two retirement plans. In the past, Retirement was organizationally located within the City's Human Resources Department. However, as of June 1995, the City Manager's Office is providing oversight to Retirement until a separate retirement department is formally established. The four functional groups within Retirement are:

- **Management and Administration** (5.0 FTE)
- **Accounting** (3.0 FTE) - General ledger accounting, retirement payroll, accounting and investment statements, accounts payable, accounts receivable, revenue tracking, real estate accounting, accounting regulations.
- **Benefits Group** (3.0 FTE) - Retirement counseling, benefits, retirement planning, beneficiary systems, survivorship counseling, life insurance, health plans, dental plans.
- **Staff Support** (3.0 FTE) - Information systems, investment reporting, banking interface, annual reports, legislation, surveys, disability

planning, records, personal computer resource, actuarial data, investment manager analysis, training.

Chart 1 shows the organization of Retirement as of April 1995.

CITY OF SAN JOSE
RETIREMENT BOARDS OF ADMINISTRATION
ORGANIZATIONAL CHART



= APPROVED STAFFING ADDITIONS WHICH ARE UNFILLED AS OF 4/21/94
TOTAL APPROVED POSITIONS = 14
TOTAL POSITIONS FILLED = 13

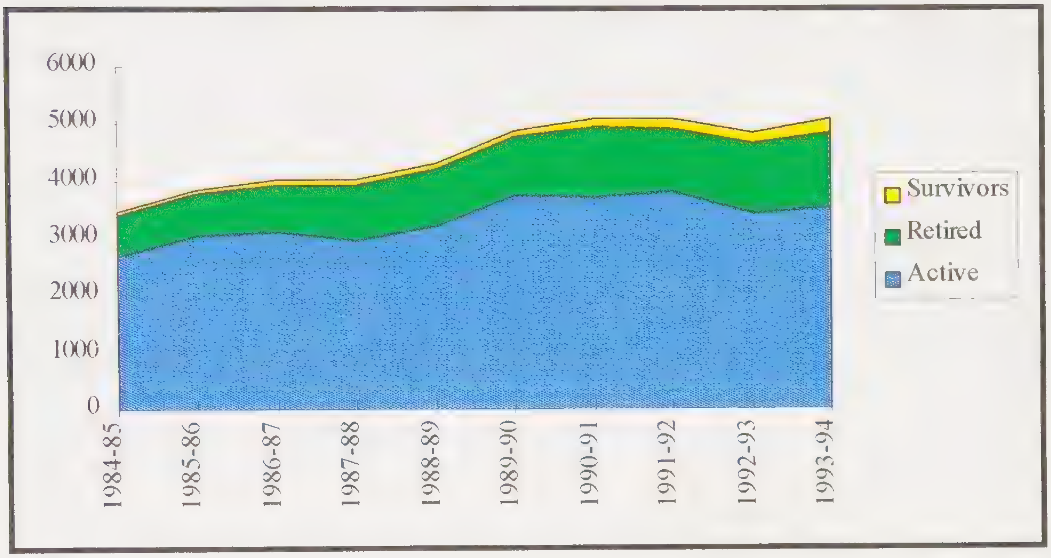
Retirement provides copies of the retirement handbooks and annual reports as well as summaries of retirement provisions to any employee on request. Retirement maintains files for each retiree; data on active employees are retrieved on the City's VAX computer system. Retirement handles retiree payroll calculations and enters changes to withholding; Payroll actually cuts the checks.

Plan Memberships And Retirements

As of June 30, 1994, there were 1,797 contributing members in the Police and Fire Department Retirement Plan (Police and Fire Plan) and 3,355 contributing members in the Federated Plan. During 1993-94, a total of 136 employees retired from City service, including 54 Police and Fire Plan members and 82 Federated Plan members. Graphs 1 and 2 show the growth in membership from 1984-85 through 1993-94 as reported in the two plans' annual reports.

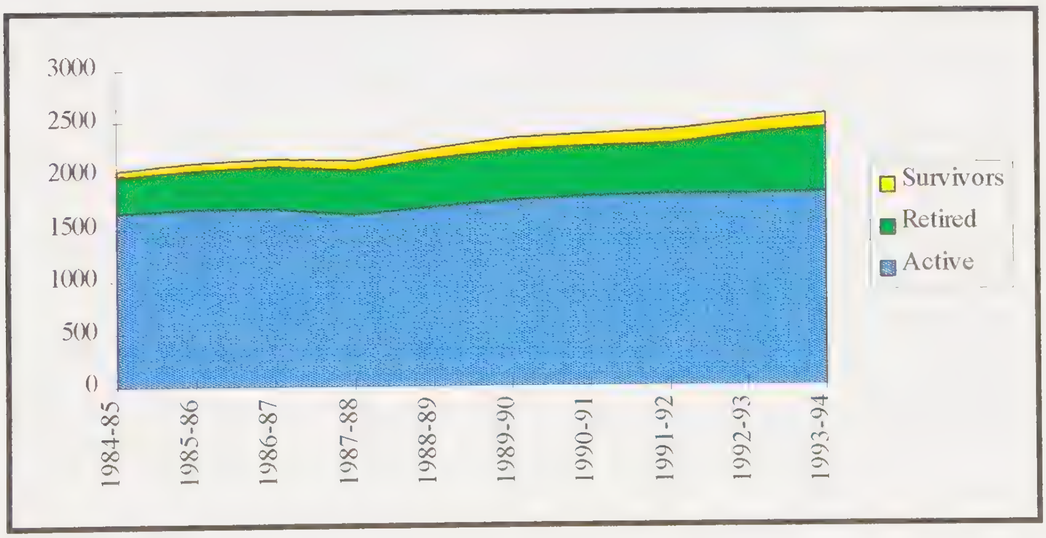
GRAPH 1

FEDERATED PLAN MEMBERS AND BENEFICIARIES 1984-85 THROUGH 1993-94



GRAPH 2

POLICE AND FIRE PLAN MEMBERS AND BENEFICIARIES 1984-85 THROUGH 1993-94

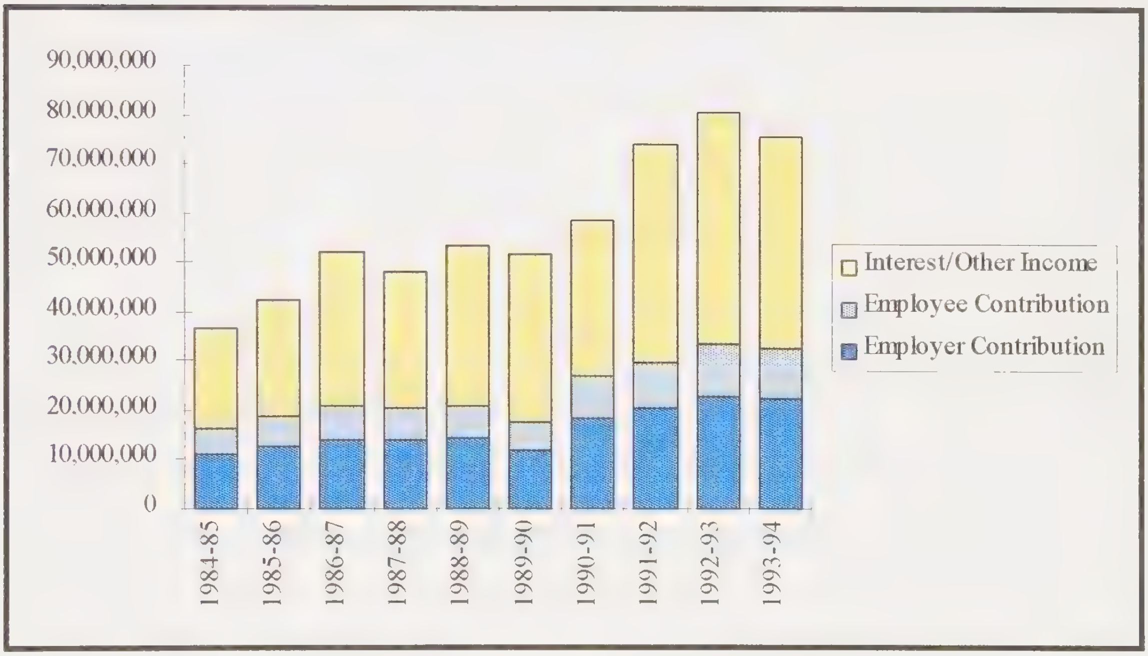


Sources And Uses Of Funds

Revenues have grown significantly for both retirement plans. Graph 3 shows the Federated Plan's revenues by type for the last ten years. Revenues declined in all categories between 1992-93 and 1993-94.

GRAPH 3

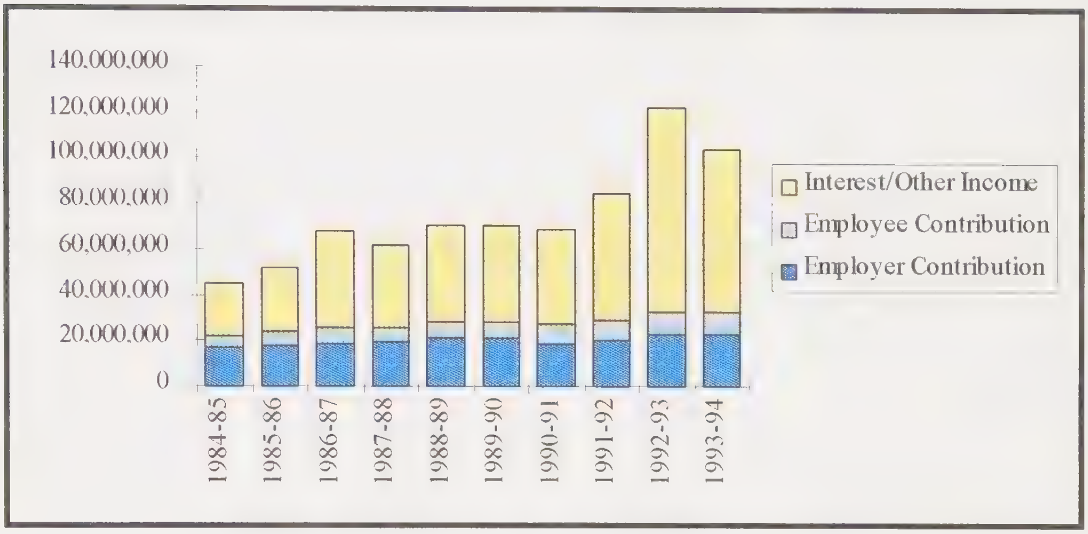
FEDERATED PLAN ANNUAL REVENUES BY TYPE 1984-85 TO 1993-94



Graph 4 shows the Police and Fire Plan's revenues by type for the last ten years. Revenues declined in all categories between 1992-93 and 1993-94.

GRAPH 4

POLICE AND FIRE PLAN
ANNUAL REVENUES BY TYPE 1984-85 TO 1993-94



Both of the retirement plans derive more than half of their annual income from their investments. According to experts, nationwide more than 80 percent of the pension payments come from capital market returns rather than from contributions. Table 2 shows the budgeted sources and uses of the Federated Employees' Retirement Fund (Fund 134) (Federated Fund). Specifically, it shows that

- Reserves have grown from $375.2 million in June 1990 to $548.3 million in June 1994 (46 percent increase);
- Annual expenses have grown from $22.2 million in 1990-91 to a budgeted $36 million in 1994-95 (62 percent increase); and
- Professional fees as a percentage of investment income have grown from 2.43 percent in 1990-91 to a budgeted 4.73 percent in 1994-95.

TABLE 2

FEDERATED EMPLOYEES' RETIREMENT FUND SOURCES AND USES 1990-91 TO 1994-95

	1990-91 (actual)		1991-92 (actual)		1992-93 (actual)		1993-94 (estimated)		1994-95 (adopted)	
BEGINNING RESERVE	$375,245,125		$411,504,860		$461,207,329		$512,209,910		$548,283,183	
SOURCES:										
City contributions	$18,306,734	31%	$20,453,908	28%	$22,800,571	29%	$20,610,858	30%	$22,671,944	30%
COL contributions	365,649	1%	357,863	0%	346,295	0%	329,666	0%	329,550	0%
Participant income	8,443,887	14%	9,423,034	13%	10,391,209	13%	9,390,224	14%	10,329,246	14%
Investment income	31,313,231	54%	43,326,961	59%	46,702,430	58%	38,844,086	56%	42,728,494	56%
Subtotal	$58,429,501	100%	$73,561,766	100%	$80,240,505	100%	$69,174,834	100%	$76,059,234	100%
USES:										
Benefit payments	$18,294,049	82%	$19,026,090	80%	$23,569,182	81%	$26,218,812	79%	$28,410,000	79%
COL payments	365,649	2%	357,863	1%	346,295	1%	329,666	1%	329,550	1%
Health insurances	2,577,322	12%	3,022,499	13%	3,784,847	13%	4,447,088	13%	4,802,800	13%
Professional fees	760,040	3%	1,240,599	5%	1,298,664	4%	1,843,507	6%	2,020,099	6%
Personal services	144,572	1%	178,914	1%	190,474	1%	220,499	1%	362,782	1%
Non-personal	28,134	0%	33,332	0%	48,462	0%	41,989	0%	56,500	0%
Subtotal	$22,169,766	100%	$23,859,297	100%	$29,237,924	100%	$33,101,561	100%	$35,981,731	100%
ENDING RESERVE	$411,504,860		$461,207,329		$512,209,910		$548,283,183		$588,360,686	
Net change	*10%*		*12%*		*11%*		*7%*		*7%*	

Table 3 shows the budgeted sources and uses of the Police and Fire Department Retirement Fund (Fund 135) (Police and Fire Fund). Specifically,

- Reserves have grown from $513.1 million in June 1990 to $785.1 million in June 1994 (53 percent increase);
- Annual expenses have grown from $15.9 million in 1990-91 to a budgeted $28.9 million in 1994-95 (82 percent increase); and
- Professional fees as a percentage of investment income have grown from 2.43 percent in 1990-91 to a budgeted 5 percent in 1994-95.

TABLE 3

POLICE AND FIRE DEPARTMENT RETIREMENT FUND
SOURCES AND USES 1990-91 TO 1994-95

	1990-91 (actual)		1991-92 (actual)		1992-93 (actual)		1993-94 (estimate)		1994-95 (adopted)	
BEGINNING RESERVE	$513,106,556		$565,216,458		$630,765,238		$730,149,581		$785,087,734	
SOURCES:										
City contributions	$18,840,246	28%	$20,625,838	25%	$23,202,530	19%	$21,345,778	26%	$23,500,000	23%
COL contributions	171,063	0%	168,064	0%	156,183	0%	146,727	0%	146,680	0%
Participant income	8,054,265	12%	8,819,728	10%	9,617,259	8%	8,671,839	11%	9,500,000	9%
Investment income	40,933,332	60%	54,524,521	65%	88,866,866	73%	51,791,786	63%	71,500,000	68%
Subtotal	$67,998,906	100%	$84,138,151	100%	$121,842,838	100%	$81,956,130	100%	$104,646,680	100%
USES:										
Benefits	$12,741,031	80%	$14,174,868	76%	$17,463,362	78%	$20,589,687	76%	$21,619,000	75%
COL	171,063	1%	168,064	1%	156,183	0%	146,727	0%	146,680	1%
Health insurances	1,858,310	12%	2,057,218	11%	2,364,346	11%	2,886,020	11%	3,116,900	11%
Professional fees	994,880	6%	1,969,136	11%	2,182,391	10%	3,107,964	12%	3,575,000	12%
Personal services	94,082	1%	178,913	1%	183,589	1%	221,079	1%	362,782	1%
Non-personal	29,638	0%	41,172	0%	108,624	0%	66,500	0%	73,000	0%
Subtotal	$15,889,004	100%	$18,589,371	100%	$22,458,495	100%	$27,017,977	100%	$28,893,362	100%
ENDING RESERVE	$565,216,458		$630,765,238		$730,149,581		$785,087,734		$860,841,052	
Net change	*10%*		*12%*		*16%*		*8%*		*10%*	

Investment Of Retirement Reserves

The retirement plans use external investment management firms (investment managers) to invest their reserves. Performance is benchmarked against related indexes on a quarterly basis. The plans also use external investment advisors to consult on investment strategy and the selection and performance assessment of external investment managers. Each plan also uses a bank to provide custodial services and securities safekeeping. Finally, each plan contracts with actuaries to estimate the plans' liability for future benefits.

Investment Policies

Each retirement board has adopted investment policies. These policies specify a target asset allocation--that is, the desired allocation of investments into stocks, bonds, and real estate. The policies also specify certain investment restrictions. Table 4 compares the asset allocation policies of the two plans.

TABLE 4

COMPARISON OF RETIREMENT PLANS' ASSET ALLOCATION POLICIES TO ACTUAL AS OF DECEMBER 31, 1994

	FEDERATED PLAN				POLICE AND FIRE PLAN			
	Minimum	Target	Maximum	Actual	Minimum	Target	Maximum	Actual
Domestic stocks	27%	32%	37%	**39%**	30%	35%	40%	**34%**
International stocks	5%	8%	10%	**6%**	0%	10%	15%	**8%**
Domestic bonds	40%	45%	50%	**43%**	25%	35%	60%	**47%**
International bonds	3%	5%	7%	**5%**	0%	10%	15%	**6%**
Real estate	7%	10%	13%	**7%**	0%	10%	15%	**5%**
Subtotals				***100%***				***100%***

Investment Advisors

The plans hire a variety of investment managers covering a variety of investment types. Their fees are usually structured on a tiered-asset basis. For example, 0.5 percent of the first $25 million in assets, plus 0.4 percent of the next $25 million, plus 0.3 percent of assets over $50 million. Table 5 shows the calculated effective annual fee rates for investment managers as of June 30, 1994, and their estimated rates of return for comparison purposes.

TABLE 5

COMPARISON OF INVESTMENT ADVISOR FEE STRUCTURES AS OF JUNE 30, 1994

Investment Manager	Type Of Assets	6/30/94 Market Value (In Millions)	1993-94 Total Rate Of Return	Effective Annual Fee Rate	Net Yield
Federated					
American National Bank	Equities	$11.4	1.4%	0.13%	1.3%
Bjurman	Equities	12.9	(18.8%)	0.90%	(19.7%)
Bond, Procope	Equities	12.4	(10.3%)	0.37%	(10.7%)
Chancellor	Equities	34.8	(0.8%)	0.25%	(1.1%)
NBS Realty	Real Estate	44.4	(1.4%)	1.03%	(2.4%)
PCM International	Intl Equities	21.3	20.8%	0.74%	20.1%
Putnam	Intl Bonds	23.7	1.5%	0.50%	1.0%
Scudder	Bonds	255.4	(1.3%)	0.08%	(1.4%)
Smoot, Miller	Equities	72.2	5.0%	0.24%	4.8%
Thompson, Siegal	Equities	40.1	(0.6%)	0.33%	(0.9%)
Wilmington	Equities	28.9	3.0%	0.32%	2.7%
Total		*$557.5*	*0.0%*	*0.31%*	*(0.3%)*
Police and Fire					
Apodaca-Johnston	Equities	$8.7	(8.7%)	1.00%	(9.7%)
Baring International	Intl Equities	53.8	27.7%	0.65%	27.1%
Boston Company	Equities	46.8	7.6%	0.40%	7.2%
Brinson Partners	Equities	44.4	2.8%	0.16%	2.6%
Chancellor	Equities	28.1	3.6%	0.33%	(3.9%)
Cisneros	Bonds	13.1	(1.1%)	0.16%	(1.3%)
Galleon	Equities	9.4	(4.1%)	0.68%	(4.8%)
IAI Minnesota	Equities	22.3	(9.5%)	0.99%	(10.5%)
IAI Houston	Equities	69.9	(2.7%)	0.45%	(3.2%)
NBS Realty	Real Estate	47.8	(1.1%)	1.03%	(2.1%)
Prudential Invmt (Global)	Intl Bonds	49.4	1.2%	0.45%	0.8%
Putnam	Bonds	66.6	(0.7%)	0.30%	(1.0%)
Rhumbline Advisors	Equities	15.3	1.3%	0.07%	1.2%
Scudder	Bonds	294.4	(1.1%)	0.09%	(1.2%)
Seneca	Equities	9.8	(1.7%)	0.68%	(2.4%)
Smith Graham	Bonds	16.4	(0.2%)	0.43%	(0.6%)
Woodford Capital	Equities	9.7	(4.1%)	0.68%	(4.8%)
Total		*$805.9*	*1.3%*	*0.49%*	*0.8%*

Portfolio Earnings

The City's rate of return on investments has been similar to those of comparable California defined benefit plans.

TABLE 6

COMPARISON OF INVESTMENT RATES
OF RETURN FOR CALIFORNIA DEFINED BENEFIT PLANS
WITH ASSETS BETWEEN $500 AND $800 MILLION

	Total Assets (In Millions)	1993 Rate of Return	Five-Year Average Rate Of Return
Ventura County	$794.3	9.30%	10.30%
Fresno County	778.7	14.50%	11.20%
City of San Jose - Police and Fire	**744.1**	**14.10%**	**10.2%**
Kern County	684.3	9.10%	10.4%
San Mateo County	596.6	9.9%	9.7%
San Joaquin County	544.6	9.0%	9.3%
Ciy of San Jose - Federated	**523.9**	**10.3%**	**10.0%**
Average	*$666.6*	*10.89%*	*10.16%*
Median	*$684.3*	*9.90%*	*10.20%*

Source: State Controller's Annual Report of Financial Transactions of Public Retirement Systems, Fiscal Year 1992-93.

Funding Status Of The Retirement Plans

Both plans use actuaries to estimate their pension benefit obligations. The most recent actuarial report for the Federated Plan was as of June 30, 1993 (issued May 1994), and the most recent report for the Police and Fire Plan was as of July 1, 1993 (issued March 1994). The actuaries use slightly different assumptions. For example, the Federated Plan assumes that its investments will

yield 8.25 percent per year, while the Police and Fire Plan assumes that its investments will yield 8 percent per year. In addition, the Federated Plan assumes that salaries for its members will increase at 5 percent per year, while the Police and Fire Plan assumes that salaries for its members will increase by 5.5 percent per year.

The pension benefit obligation is an estimate. Changes to retirement plan benefits have a major effect on the estimated pension benefit obligation. For example, the 1992 plan amendments to the Police and Fire Plan increased the pension benefit obligation by approximately $38 million.

In addition, the City has already seen the effects of changes in actuarial assumptions. In estimating the June 30, 1992, liability, the Federated Plan investment rate of return assumption was decreased from 9 percent to 8.75 percent and the assumed rate of salary increases was decreased from 5.75 percent to 5.5 percent. These changes caused the total Federated Plan pension benefit obligation as of June 30, 1992, to increase by an additional $11,053,000--to a total of $513,093,000. Furthermore, in estimating the June 30, 1993, Federated Plan pension liability, the interest rate was reduced once again from 8.75 percent to 8.25 percent and the assumed rate of salary increases was reduced from 5.5 percent to 5 percent. These changes increased the unfunded Federated Plan pension benefit obligation as of June 30, 1993, to $117,503,000.

As of June 30, 1993, the Police and Fire Plan showed a $10.6 million excess of assets over its estimated pension benefit obligation. Conversely, as of June 30, 1993, the Federated Plan showed an unfunded pension benefit obligation of $117.5 million. As Table 7 shows, the Police and Fire Plan was fully funded as of June 30, 1993, while the Federated Plan was 81 percent funded.

TABLE 7

COMPARISON OF FEDERATED PLAN'S AND POLICE AND FIRE PLAN'S NET ASSETS AND PENSION BENEFIT OBLIGATION FOR JUNE 1990 TO JUNE 1993

(In thousands)

	June 30, 1990	June 30, 1991	June 30, 1992	June 30, 1993
Federated Plan				
Net assets available for benefits	$375,245	$411,505	$461,207	$512,210
Pension benefit obligation	411,040	470,381	513,093	629,713
Unfunded pension benefit obligation	($35,795)	($58,876)	($51,886)	($117,503)
Funded Status	*91.3%*	*87.5%*	*89.9%*	*81.3%*
Police and Fire Plan				
Net assets available for benefits	$513,107	$565,216	$630,765	$730,149
Pension benefit obligation	$499,289	$550,750	$617,263	$719,519
Funded Status	*102.8%*	*102.6%*	*102.2%*	*101.5%*

In comparison, PERS was 90.6 percent funded as of June 30, 1992, and five comparable California defined benefit programs were funded at the following levels in 1992:

Retirement Plan	Funding Ratio	Valuation Date
San Mateo County	73.1%	7/1/92
Kern County	77.2%	6/30/92
Ventura County	86.6%	6/30/92
City of San Jose Federated	89.9%	6/30/92
Fresno County	94.6%	6/30/92
City of San Jose Police and Fire	102.2%	6/30/92
San Joaquin County	102.5%	1/1/92

FINDING I

OPPORTUNITIES EXIST TO INCREASE RETIREMENT FUND EARNINGS AND REDUCE INVESTMENT COSTS BY (1) ENFORCING PERFORMANCE OBJECTIVES ON INVESTMENT MANAGERS, (2) INCREASING USE OF PERFORMANCE-BASED FEES, (3) REDUCING THE NUMBER OF INVESTMENT MANAGERS, AND (4) INCREASING USE OF INDEX FUNDS

The Federated City Employees' Retirement System's (Federated Plan) and the Police and Fire Department Retirement Plan's (Police and Fire Plan) investment portfolios are composed of fixed income securities (bonds), equities (stocks), and real estate. The two plans use 24 external investment management firms to manage the $1.4 billion portfolio. Over the past ten years, the plans' bond managers generally outperformed the market indexes. However, over that same period, the two plans have engaged 21 different outside equity managers who have cumulatively performed below equity industry benchmarks. Our review revealed that

- The majority of investment managers have underperformed the performance objectives outlined in the retirement funds' investment policies;
- The retirement plans do not have a formal probationary process for investment managers;
- Investment manager contracts do not specify management style, performance standards, or probationary processes;
- Eight of the investment management firms were founded less than ten years ago;
- Only one manager is paid a performance-based fee; and
- The large number of investment managers increases costs and imposes a burden on Retirement Program staff.

Finally, most public pension plans have a larger portion of their equity portfolios invested in equity indexes. For example, the California Public

Employees' Retirement System (PERS) has 80 percent of its equity portfolio invested in an equity index. In contrast, the City's retirement plans only have 5 to 6 percent of their domestic equity portfolios invested with index managers. If the retirement plans' equity portfolios had been invested in an equity index fund instead of with the variety of managers that were used, we estimate that the portfolios could have earned an additional $72.8 million over the last ten years and saved about $10 million in management fees paid to equity managers. These additional earnings and fee savings would have improved upon the funded status of both retirement plans as of June 30, 1993. Further, we estimate the retirement funds may be able to earn up to $7.1 million a year more and reduce investment management fees by up to $1.9 million annually if they index their equity portfolios. Accordingly, the boards of administration for the retirement plans should increase the use of equity index funds. In addition, the boards should establish formal probationary processes for investment managers whose performance falls below applicable standards, increase use of performance-based fees, and reduce the number of investment managers.

The Retirement Fund Portfolios Totaled $1.4 Billion As Of December 31, 1994

As of December 31, 1994, the two plans held nearly $1.4 billion in investments including stocks, bonds, and real estate. Both plans contract with external investment managers to manage their assets because neither system places its own investments. The funds of the two plans are maintained on an entirely separate basis. The Police and Fire Plan contracts with 17 investment management firms, an investment advisor, and a custodian bank to manage its assets. The Federated Plan contracts with 11 investment management firms, another investment advisor, and another custodian bank. Included in the 17 and 11 investment management firms noted above are four firms that work for both

retirement funds. Table 8 shows the allocation of Police and Fire Fund's and Federated Fund's assets by type of investment and investment manager.

TABLE 8

RETIREMENT FUND INVESTMENT PORTFOLIOS AS OF DECEMBER 31, 1994

Type Of Investment	Police And Fire Plan Investment Managers (In millions)			Federated Plan Investment Managers (In millions)		
Equities:	IAI Houston	$73.9	*8.9%*	Smoot, Miller	$72.8	*12.8%*
	Boston Company	49.0	*5.9%*	Thompson, Siegel	43.5	*7.7%*
	Brinson Partners	45.8	*5.5%*	Chancellor	37.4	*6.6%*
	Chancellor	30.0	*3.6%*	Wilmington	29.2	*5.1%*
	IAI Minnesota	28.0	*3.4%*	Bjurman	14.7	*2.6%*
	Rhumbline	17.7	*2.1%*	Bond, Procope	12.7	*2.2%*
	Apodaca-Johnson	11.5	*1.4%*	ANB	12.0	*2.1%*
	Seneca	10.1	*1.2%*		$222.3	*39.2%*
	Woodford	10.1	*1.2%*			
	Galleon	9.7	*1.2%*			
		$285.8	*34.4%*			
International Equities:	Baring[1]	$60.4	*7.3%*	PCM	$32.0	*5.6%*
Bonds:	Scudder	$290.1	*34.9%*	Scudder	$243.4	*42.9%*
	Putnam	68.4	*8.2%*			
	Smith Graham	17.7	*2.1%*			
	Cisneros	14.2	*1.7%*			
		$390.4	*47.0%*			
International Bonds:	Global Advisors	$51.2	*6.2%*	Putnam	$28.7	*5.1%*
Real Estate:	NBS Realty	$42.8	*5.2%*	NBS Realty	$41.4	*7.3%*
	Total	$830.6	*100.0%*	Total	$567.8	*100.0%*

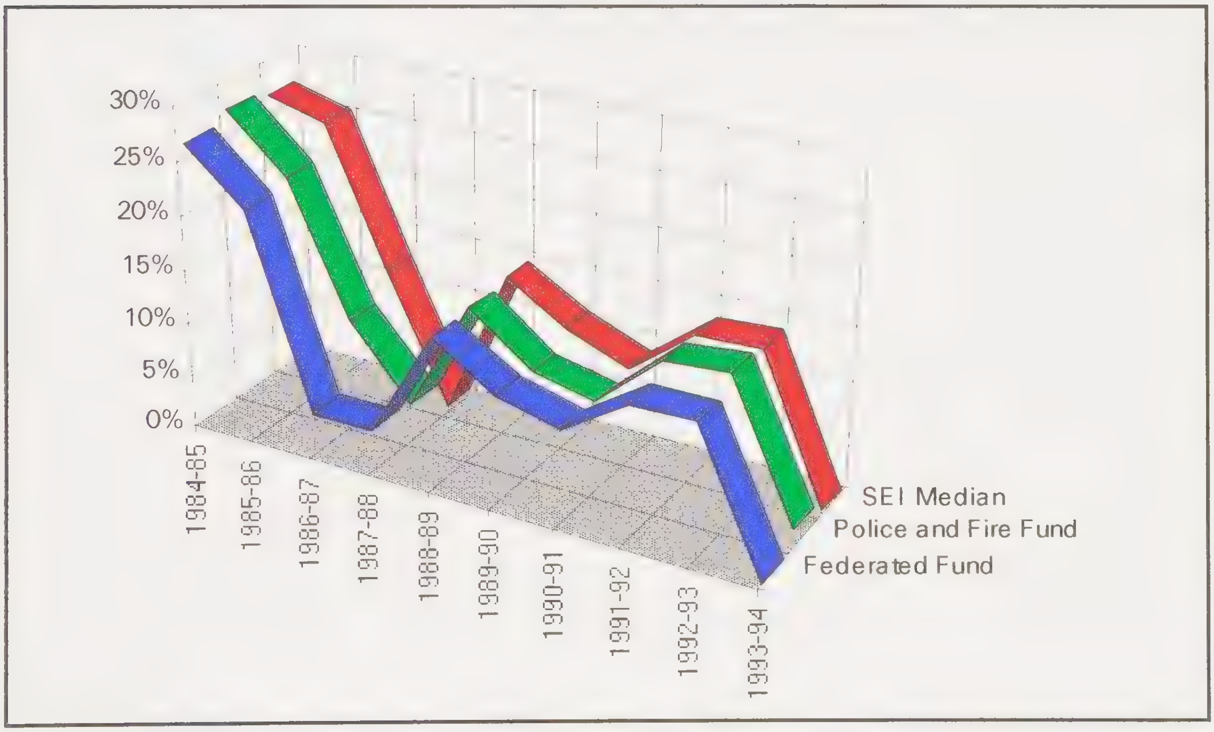
[1] Baring International Investment Limited has managed an international portfolio for the Police and Fire Fund since 1992. Pursuant to Baring's bankruptcy earlier this year, the retirement board reviewed the relationship and determined that none of the assets managed by Baring were at risk because they are actually held at Bankers' Trust. The investment management relationship continues under Baring's new parent company, I.N.G. of the Netherlands.

Retirement Fund Yields

The retirement funds' total annual yields include investment income and realized and unrealized losses.[2] Investment income includes bond interest, stock dividends, and real estate rental income. Realized and unrealized losses in asset value vary dramatically from year to year as markets fluctuate. Graph 5 shows the past ten years' yields of the retirement funds and the SEI Median (a benchmark comparison).

GRAPH 5

RETIREMENT FUNDS' TOTAL ANNUAL YIELDS COMPARED TO PUBLIC FUND MEDIAN YIELDS FOR 1984-85 THROUGH 1993-94



---

[2] Realized losses are the result of selling a security for less than its cost. Unrealized losses result when the current market value of a security is less than its cost.

As Graph 5 shows, the funds realized their highest yields during 1984-85 (the Federated Fund yielded 26.3 percent, the Police and Fire Fund yielded 27.4 percent, and the SEI Median yielded 26.8 percent). Lowest yields occurred during 1993-94 (the Federated Fund yielded 0.0 percent, the Police and Fire Fund yielded 1.7 percent, and the SEI Median yielded 0.4 percent).

On Average From 1984-85 To 1993-94, The Plans' Bond Managers Outperformed Market Indexes While The Equity Managers Underperformed Market Indexes

From 1984-85 to 1993-94, both retirement funds' domestic bond portfolios outperformed the annualized rate of return[3] of the Lehman Brothers Bond Index (a benchmark comparison).[4] However, both domestic equity portfolios underperformed the annualized rate of return of the Standard & Poor's 500 Index (S&P 500)[5] over that same ten-year period. Table 9 shows these long-term rates of return.

---

[3] According to a Bankers' Trust tutorial, annualizing rates of return is useful when data is available for more than one year. In general, the formula requires calculation of the product of a series of relative returns raised to the power of the number of observations per year divided by the number of observations that you have.

[4] The Lehman Brothers Government/Corporate Bond Index is a composite of publicly issued, fixed rate, non-convertible, domestic bonds.

[5] The Standard & Poor's 500 Index is a composite of 400 industrial, 40 financial, 40 utility, and 20 transportation common stocks.

TABLE 9

ANNUALIZED RATES OF RETURN OF RETIREMENT PORTFOLIOS COMPARED TO THE ANNUALIZED RATES OF RETURN OF THE RELEVANT BENCHMARK INDEXES FROM 1984-85 TO 1993-94

	Federated Plan Portfolio	Police and Fire Plan Portfolio
Domestic Equities	11.7%	14.0%
S&P 500	*15.1%*	*15.1%*
Domestic Bonds	12.1%	12.2%
Lehman Brothers Bond Index	*11.6%*	*11.6%*
Total Fund	11.1%	12.3%
SEI Median	*12.4%*	*12.4%*

Results Vary From One Period To The Next

The respective retirement boards receive quarterly performance measurement reports from their investment advisors including yields for the last quarter and last 12 months, last 36 months, and last 60 months on a rolling basis. It should be noted that even in a large, diversified portfolio, the yield will vary dramatically from one period to the next. For example, as stated above, the Federated Plan equity portfolio yielded about 11.7 percent per year from 1984-85 to 1993-94 while the Police and Fire Plan equity portfolio yielded about 14.0 percent per year and the S&P 500 yielded about 15.1 percent. However, annual yields on the S&P 500 varied from a loss of 6.9 percent in 1987-88 to a gain of 35.8 percent in 1985-86. Table 10 compares the yields of the retirement funds to the S&P 500 from 1984-85 through 1993-94.

TABLE 10

RETIREMENT FUNDS' EQUITY PORTFOLIO RESULTS FROM 1984-85 TO 1993-94

	Federated	Police and Fire	S&P 500 Index Rate
1984-85	25.6%	25.3%	31.0%
1985-86	34.5%	35.0%	35.8%
1986-87	8.3%	21.3%	25.2%
1987-88	(7.2%)	(6.9%)	(6.9%)
1988-89	16.9%	19.2%	20.5%
1989-90	14.2%	14.5%	16.4%
1990-91	6.8%	4.8%	7.4%
1991-92	10.3%	11.2%	13.5%
1992-93	13.1%	17.2%	13.6%
1993-94	0.1%	4.4%	1.4%
Average Rate of Return	*12.3%*	*14.6%*	*15.8%*
Annualized Rate of Return	*11.7%*	*14.0%*	*15.1%*

It should be noted that although the Police and Fire Plan's equity portfolio outperformed the S&P 500 in 1992-93 and 1993-94, its average yield for the ten-year period underperformed the S&P 500. In addition, the Federated Plan's equity portfolio underperformed the S&P 500 every year for the last ten years.

The Majority Of Investment Managers Have Underperformed The Performance Measures Stipulated In The Retirement Funds' Investment Policies

Police And Fire Plan Investment Manager Performance

The Police and Fire Plan investment policy stipulates minimum performance standards for its investment managers. Managers are expected to achieve these results over a rolling five-year time period or a full market cycle. The minimum standards include the following performance rankings:

- Equity and fixed income managers must rank in the top third of equity and fixed income managers, respectively, (rank number 1 to 33) and

- International equity, international bond, and real estate managers should rank in the top half of international equity, international bond, and real estate managers, respectively, (rank number 1 to 50).

In addition, managers must exceed the performance of specified market indexes:

- Equity managers should exceed the performance of the S&P 500;

- Bond managers should exceed the Salomon Brothers Broad Investment Grade Bond Index;[6]

- International equity managers should exceed the performance of the Morgan Stanley Capital International EAFE Index;[7]

- International bond managers should exceed the Salomon Brothers World Government Bond Index; and

- Real estate managers should exceed the National Council of Real Estate Investment Fiduciaries (NCREIF) index.

Finally, managers must not assume risk in excess of relevant markets without corresponding increases in returns.

Police And Fire Plan Investment Managers--Deficient Rankings

SEI Capital Resources is the investment advisor to the Police and Fire Plan's retirement board.[8] Table 11 summarizes the individual investment

---

[6] The Salomon Brothers Broad Investment Grade Bond Index is a composite of institutionally traded U.S. Treasury, agency, mortgage, and corporate securities.

[7] The Morgan Stanley Capital International (MSCI) EAFE Index is a composite of approximately 1,000 equity securities representing the stock exchanges of Europe, Australia, New Zealand, and the Far East.

[8] SEI has been notified that it was not selected as a finalist in the new advisor selection process; it is SEI's understanding that it will be terminated upon receipt of its final June 30, 1995, reports.

manager rankings as of December 31, 1994, that SEI Capital Resources provided to the Police and Fire Plan's retirement board.

TABLE 11

POLICE AND FIRE PLAN'S INVESTMENT MANAGER INDIVIDUAL RANKINGS AS OF DECEMBER 31, 1994

	Specified Minimum Performance Ranking	Ranking (Highlighted numbers indicate deficient ranking)						
		Last Quarter	Last 2 Quarters	Last 3 Quarters	Last Year	Last 2 Years	Last 3 Years	Last 5 Years
Domestic Stocks								
IAI Houston	1 to 33	16	12	22	**44**	**68**	**90**	**69**
Chancellor	1 to 33	16	13	**41**	**43**			
Galleon	1 to 33	**87**	**58**	**98**				
Woodford	1 to 33	30	33	**68**				
Brinson	1 to 33	**87**	**71**	29	**38**			
Boston Company	1 to 33	**56**	**70**	**58**	**41**			
Seneca	1 to 33	**52**	**56**	**71**				
Rhumbline	1 to 33	21	28	27	27	**45**		
IAI Minneapolis	1 to 33	n/a	n/a	n/a	n/a			
Apodaca-Johnston	1 to 33	n/a	n/a	n/a				
Domestic Bonds								
Scudder	1 to 33	6	12	**53**	**65**	31	20	14
Putnam	1 to 33	19	31	**38**	**62**	**50**		
Smith Graham	1 to 33	24	3	18	17	**47**		
Cisneros	1 to 33	n/a	n/a	n/a	n/a			
International Stocks								
Baring International	1 to 50	**64**	38	50	**69**	**62**	25	
International Bonds								
Global Advisors	1 to 50	n/a	n/a	n/a	n/a	n/a	n/a	
Real Estate								
NBS Realty Advisors	1 to 50	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Source: SEI Performance Measurement Report for December 31, 1994

As Table 11 shows, as of December 31, 1994, most of the Police and Fire Fund's domestic equity managers were underperforming their peers according to the latest available information about equity fund rankings. Specifically, only one of 11 reported stock and bond managers ranked within the top third of similar investment managers. In addition, only one of the Fund's global and real estate managers ranked in the top half of similar investment managers. It should be noted that the Fund retained only one bond manager and one equity manager for the entire five-year period shown in Table 11. Further, the investment advisor did not provide rankings for two of the equity managers the Fund used during the five-year period in Table 11. Table 12 summarizes these results.

TABLE 12

NUMBER OF POLICE AND FIRE PLAN INVESTMENT MANAGERS THAT MET INVESTMENT POLICY PERFORMANCE OBJECTIVES FOR RANK AS OF DECEMBER 31, 1994

Asset Type	Ranking Specified In Investment Policy	Number Of Managers Meeting The Ranking Requirement*
Stocks	Top Third	0 out of 8 reported
Bonds	Top Third	1 out of 3 reported
Global bonds	Top Half	0 reported
Global equities	Top Half	1 out of 1 reported
Real estate	Top Half	0 reported
Portfolio Total		*2 out of 12 reported*

* Based on a rolling five-year basis or the longest time period available.

Police And Fire Plan Investment Managers--Deficient Returns

In addition to deficient investment manager rankings, the majority of the Police and Fire Fund's managers underperformed their indexes during 1994. In fact, only 3 of the 12 managers reporting returns for the entire year beat their indexes and only three reporting managers have been with the fund for a full five years. Of those, Scudder (domestic bonds) was outperforming its index on a rolling five-year basis as of December 31, 1994. Conversely, Investment Advisors Houston's (domestic stocks) five-year rate of return of 8.1 percent fell below the S&P 500 rate of return of 8.7 percent. Table 13 summarizes these deficiencies.

TABLE 13

NUMBER OF POLICE AND FIRE PLAN INVESTMENT MANAGERS THAT MET RATE OF RETURN PERFORMANCE OBJECTIVES SPECIFIED IN THE INVESTMENT POLICY AS OF DECEMBER 31, 1994

Asset Type	Index Specified In The Investment Policy	1-Year Index Rate Of Return	Number Of Managers Meeting That Rate Of Return During 1994	5-Year Index Rate Of Return	Number Of Managers Meeting That Rate Of Return Over A 5-Year Period
Stocks	S&P 500	1.3%	1 out of 6 reported	8.7%	0 out of 1 reported
Bonds	Salomon Broad	(2.9%)	2 out of 4 reported	7.8%	1 out of 1 reported
Global bonds	Salomon World	2.3%	0 out of 1 reported	9.7%	0 reported
Global equities	MSCI EAFE	7.8%	0 out of 1 reported	1.5%	0 reported
Real estate	NCREIF	n/a	0 reported	n/a	0 reported
Portfolio Total			*3 out of 12 reported*		*1 out of 2 reported*

Federated Plan Investment Manager Performance

The Federated Plan investment policy also establishes performance objectives for its portfolio managers. Specifically, it stipulates that they

- Rank in the top half of managers investing in the same broad class of investments (rank number 1 to 50);
- Rank in the top half of investment managers utilizing a similar investment style (rank number 1 to 50); and
- Achieve returns that exceed the appropriate indexes.

Callan Associates is the investment advisor to the Federated Plan's retirement board. Table 14 summarizes the rankings of the Federated Plan investment managers as of December 31, 1994, that Callan Associates provided to the Federated Plan's retirement board.

TABLE 14

FEDERATED PLAN INVESTMENT MANAGER RANKINGS WITHIN THE ASSET CLASS AS OF DECEMBER 31, 1994

	Specified Minimum Performance Ranking	Ranking (Highlighted numbers indicate deficient ranking)				
		Last Quarter	Last Year	Last 2 Years	Last 3 Years	Last 5 Years
Domestic Equities						
ANB Investment Management	1 to 50	29	38	**61**		
Bjurman	1 to 50	35	**95**			
Bond, Procope	1 to 50	**67**	**95**	**100**		
Chancellor	1 to 50	21	**65**	**84**		
Smoot	1 to 50	26	**65**	n/a	**73**	**90**
Thompson	1 to 50	**63**	**65**	n/a	58	**63**
Wilmington	1 to 50	47	**56**	n/a	42	**69**
Domestic Bonds						
Scudder	1 to 50	8	**73**	n/a	36	32
International Equities						
PCM International	1 to 50	**77**	41	**95**	**96**	
International Bonds						
Putnam International	1 to 50	**94**	**78**	**73**	**59**	
Real Estate						
NBS Realty Advisors	1 to 50	**100**	**95**	n/a	39	12

Source: Callan Associates Investment Measurement Review as of December 31, 1994.

Federated Plan Investment Managers--Deficient Rankings

As shown in Table 14, the performance of all seven of the Federated Plan equity managers ranked in the bottom half of a broad database of domestic equity managers on a rolling five-year basis or the longest time period available. Furthermore, as shown in Table 15, their rankings did not improve significantly when compared to managers with similar investment styles. It should be noted that the equity manager that ranked 100th out of 100 equity managers based on two-year annualized performance (Bond, Procope) has been terminated.

TABLE 15

NUMBER OF FEDERATED PLAN INVESTMENT MANAGERS THAT MET INVESTMENT POLICY PERFORMANCE OBJECTIVES FOR RANK AS OF DECEMBER 31, 1994

Asset Type	Number Of Managers Ranking In The Top Half Of Managers In Their Asset Class*	Number Of Managers Ranking In The Top Half Of Managers With Similar Styles*
Stocks	0 out of 7 reported	0 out of 7 reported
Bonds	1 out of 1 reported	1 out of 1 reported
Global bonds	0 out of 1 reported	0 out of 1 reported
Global equities	0 out of 1 reported	0 out of 1 reported
Real estate	1 out of 1 reported	1 out of 1 reported
Portfolio Total	***2 out of 11 reported***	***2 out of 11 reported***

* Number of managers meeting that ranking on a rolling five-year basis or the longest time period available.

Federated Plan Investment Managers--Deficient Returns

In addition to deficient investment manager rankings, the majority of the Federated Fund's managers underperformed the market indexes during 1994. In fact, only one of the 11 managers reporting returns for the entire year (ANB

Investment Management) beat the indexes in 1994. However, four managers (Thompson, Wilmington, Scudder, and NBS) were beating the indexes' five-year rates of return as of December 31, 1994. It should be noted that only five managers have been with the Federated Fund for five years or more. Table 16 summarizes these results.

TABLE 16

NUMBER OF FEDERATED PLAN INVESTMENT MANAGERS THAT MET INVESTMENT POLICY PERFORMANCE OBJECTIVES FOR RATE OF RETURN AS OF DECEMBER 31, 1994

Asset Type	Index Specified In The Investment Policy	1994 Market Index Rate Of Return	Number Of Managers Meeting That Rate Of Return During 1994	5-Year Market Index Rate Of Return	Number of Managers Meeting That Rate Of Return Over A 5-Year Period
Stocks	S&P 500[9]	1.3%	1 out of 7 reported	8.7%	2 out of 3 reported
Bonds	Salomon Broad[9]	(2.9%)	0 out of 1 reported	7.8%	1 out of 1 reported
Intl Bonds	Salomon Non-US[10]	6.0%	0 out of 1 reported	11.4%	0 reported
Intl Stocks	MSCI EAFE	7.8%	0 out of 1 reported	1.5%	0 reported
Real Estate	NCREIF	4.6%	0 out of 1 reported	(0.5%)	1 out of 1 reported
Portfolio Total			*1 out of 11 reported*		*4 out of 5 reported*

The Retirement Plans Do Not Have A Formal Probationary Process For Investment Managers

The retirement plans do not have a formal probationary process for investment managers whose performance has been deficient. When concerns are raised about a portfolio manager's performance, the Retirement Program (Retirement) staff puts the manager on an informal "watch list." Although

[9] Note that the investment policy specifies "appropriate index" but not one particular index.

[10] The Salomon Brothers Non-U.S. World Bond Index consists of non-U.S. government bonds, Eurobonds, and foreign bonds rated at least AA.

Retirement staff stays in contact with those managers on the watch list, there is no formal process for the Retirement staff regarding maintaining and reporting on the managers on the watch list. Further, Retirement staff does not regularly publish the watch list for the retirement boards to review even though a portfolio manager may not be meeting its investment policy performance benchmarks.

Both the Federated Fund and Police and Fire Fund have investment policies that state that investment managers are expected to achieve performance goals over a rolling five-year time period or a full market cycle. For example, the Federated Plan investment policy states that

> *Investment performance will be measured quarterly but it is not expected that the performance goals identified below will be satisfied in any single quarter or year. It is expected that these goals will be satisfied over a rolling five-year period or a full market cycle. However, action by the Board with regard to retention or dismissal of investment managers is not precluded by virtue of these time periods.*

Each of the eight investment manager contracts we reviewed contained a 30-day termination clause. In addition, the funds' investment advisors provide quarterly assessments of investment manager performance. Furthermore, the Retirement administrator recently forwarded to the retirement boards a recommendation to

> *Use the guidelines set forth in the Investment Policy to judge the performance of investment managers and adhere to that when determining to terminate an investment manager. Apply the same guidelines during interim periods, and if managers fail to meet them, they should be reviewed for other larger changes that may be causing poor performance* [and] *terminated if necessary.*

The above policy and recommendation notwithstanding, the plans do not have established investment manager probationary or disciplinary procedures. During our surveys of other jurisdictions, we found that the investment manual of

the San Diego City Employees' Retirement System describes the process for dealing with investment manager deficient performance. San Diego's performance objectives for investment managers are similar to those of San Jose's retirement plans. The manual outlines a formal probationary process:

> *In any quarter in which manager performance falls more than 25% below the established objective for an equity manager or more than 10% below the established objective for a fixed income manager, that manager may be flagged for ongoing performance monitoring and review. This review process shall also consider manager performance relative to other managers of a similar investment style. Once a manager has been flagged for ongoing performance tracking, the following procedures shall be followed:*
>
> - *For two consecutive deficient quarters or two within the last six - The manager shall be provided written communication expressing the Board's concern over the underperformance.*
>
> - *For three consecutive deficient quarters or three within the last eight - The manager shall be directed to appear before the Investment Committee on the next available meeting date to explain the reasons for the underperformance and indicate what actions are being taken to correct the situation.*
>
> - *For four consecutive deficient quarters or four within the last nine - The Investment Committee should consider the appropriateness of termination of that manager.*

The State Teachers Retirement System (STRS) judges manager performance on similar criteria. Each manager must

(1) Beat the S&P 500 by 200 basis points (equity managers); otherwise, the fund is better off indexing;

(2) Score in the 50th percentile or higher against managers with comparable investment styles; and

(3) Score 100 basis points over the comparable benchmark index.

STRS compares these statistics for three-year and five-year rolling averages. If a manager does not meet two of these criteria, it is placed on a watch list. After

six months on the watch list, it is put on probation. STRS spends considerable effort selecting investment managers, so as long as the management team stays intact, STRS will give them some time to recover. In addition, if a manager has been with STRS for several years, that may buy the investment manager a few additional months to recover. But STRS has learned that, for whatever reason, "*funds do, periodically, explode*" and must be terminated before losses grow.

The importance of monitoring investment managers is reiterated in the GFOA publication, Investing Public Funds, which also stresses the fiduciary responsibility to monitor investment managers. Specifically,

> *A manager who consistently falls short of these norms should be monitored carefully. As fiduciaries, fund trustees could be criticized for continuing to retain the services of a subpar money manager.*

In our opinion, the Retirement administrator should draft procedures to establish a formal investment manager probationary process for retirement board consideration and approval. As with the San Diego policy, these procedures could lead to, but would not dictate, termination of a manager. They should, however, require monthly and/or quarterly follow-up, reassessment, and reporting on the status of any manager whose performance has been deficient.

Quarterly Reports On Investment Manager Performance Are Voluminous;
Poor Performance Is Not Expressed As A Noncompliance With The Investment Policy

Retirement board members have recently asked the investment managers and investment advisors to standardize their reporting and prepare executive summaries. The reports from the external managers can be voluminous. Board members receive large quantities of information in a variety of formats without executive summaries and without specific staff recommendations. In our opinion, staff and the boards should work together to devise a way to clearly

point out deficient performance when it occurs and regularly report such incidents to the retirement boards as a noncompliance with the investment policy.

Investment Manager Contracts Do Not Specify Management Style, Performance Standards, Or Probationary Processes

Our review of eight retirement fund investment manager contracts revealed that

- Management style is usually not defined in the contracts (the exceptions are the Rhumbline and ANB contracts that specify S&P 500 Index management) and
- Although termination procedures are spelled out in the contracts (30-day written notice for termination and three-day notice for cessation of activity), specific performance criteria are not defined in the contracts. For example, specific performance benchmark indexes and manager ranking criteria are not defined in the contracts.

Copies of Retirement's investment policies were attached to all eight of the contracts we reviewed. However, for at least three of the contracts that also cite San Jose Municipal Code restrictions on investment, copies of those provisions were not attached. In addition, none of the eight contracts we reviewed referenced, or included as an attachment, the City Council's Policy #0-15[11] "*Code of Ethics for Officials and Employees of San Jose*" which includes a section entitled "***Acceptance of Favors and Gratuities***." In our opinion, staff could help ensure that investment managers have a complete understanding of the retirement investment programs by revising the standard language in investment manager, advisor, and/or custodian bank contracts to include (1) benchmark

---

11 See Appendix B for a full text of City Council Policy #0-15.

performance standards, (2) a process for dealing with underperformance, (3) timeliness requirements for reporting, and (4) reference to City Council Policy #0-15. It should be noted that according to the Retirement administrator, he has already revised investment manager contracts to include a section on management style.

Eight Investment Managers Have Been In Business For Less Than Ten Years

The San Jose Municipal Code establishes certain restrictions on investment counselors that the retirement boards hire. Code sections 3.28.370 (Federated Plan) and 3.32.400 (Police and Fire Plan) specify that investment firms must be registered and prohibit hiring a *"person or association who or which has not been continuously engaged in such business for a period of not less than ten years, including any immediate predecessor in interest."*

Apparently, the Code has been interpreted to mean that experienced personnel could substitute for longevity of the investment management firm. As a result, eight of the investment management firms the Police and Fire Plan has hired since 1992 have been in business for less than ten years. They include six stock managers:

- Apodaca Johnston Capital Management - founded August 1987
- Brinson Partners - founded October 1989
- New Amsterdam Partners - founded February 1986
- Rhumbline - founded August 1990
- Seneca - founded February 1992
- Woodford - founded December 1990

and two bond managers:

- Cisneros - founded May 1989
- Smith, Graham - founded March 1990

In our opinion, the retirement boards should (1) reaffirm that these firms have sufficient experience to invest Retirement assets; (2) reassess the San Jose Municipal Code experience qualifications for investment; and (3) either propose that the language in the Code be clarified or reassess the status of these managers as necessary.

Only One Manager Is Paid A Performance-Based Fee;
Other Pension Plans Make Greater Use Of Performance-Based Fees

Most of the City's investment manager fees (whether stocks, bonds, or real estate) are based on the size of the portfolio. For example, Brinson Partners charges the Police and Fire Plan for stock portfolio management based on the following formula:

First \$5 million in assets:	0.75 percent times month-end market value
Next \$10 million in assets:	0.60 percent times month-end market value
Next \$25 million in assets:	0.40 percent times month-end market value
Next \$60 million in assets:	0.25 percent times month-end market value

Only one of the City's portfolio managers, Chancellor, has a performance-based fee contract. The fee structure is based on meeting or outperforming the Barra Growth Index:

Base fee:	0.25 percent times month-end market value
Normal fee:	If returns exceed the Barra Growth Index by 1.75 percent, the management fee is 0.5 percent times month-end market value.
Maximum fee:	If returns exceed the Barra Growth Index by more than 1.75 percent, the management fee increases to a maximum of 0.75 percent times month-end market value.

Our review revealed that increasing numbers of pension plans are negotiating performance-based fee arrangements. A 1994 survey by Institutional Investor revealed that 24.4 percent of respondents had negotiated performance-based fees versus 19.5 percent in 1992. The survey found that *"Pension officers are bargaining harder with investment managers over fees and demanding better results for what they're paying."*

STRS pays all of its domestic equity managers based on performance. STRS hires active equity managers in areas where they can add value, expecting that they will beat the market index. STRS investment managers are typically paid as follows:

Base fee:	One-third of the negotiated normal fee
Normal fee:	The manager must achieve returns that exceed the S&P 500 by 200 basis points (2 percent) to receive its normal, negotiated fee.
Performance fees:	If returns exceed the S&P 500 by more than 200 basis points, the manager shares in the earnings through various negotiated formulas.

In our opinion, Retirement should try to motivate its external investment managers and reduce the costs of underperforming managers by negotiating more performance-based fees.

The Large Number Of Investment Managers Increases Costs
<u>And Imposes A Considerable Burden On The Retirement Program</u>

As of June 30, 1994, the Police and Fire Plan was contracting with 17 investment managers and the Federated Plan was contracting with 11 investment managers. In addition, each plan was contracting with an investment advisor, a custodian bank, and an actuary. For example, the Police and Fire Plan was using nine domestic equity portfolio managers to manage approximately $257 million in assets at an annual cost of approximately $1,269,000. Similarly, the Federated Plan was contracting with seven domestic equity portfolio managers to manage an estimated $214 million in assets at an estimated annual cost of $675,000.

During 1993-94, Retirement nearly doubled in size from 7 to 13 full-time staff members. As part of this expansion, new staff was added to help monitor investments and manager performance. However, the number of investment managers has also increased. As Table 17 shows, from 1987-88 to 1993-94 both retirement funds dramatically increased the number of investment managers they were using. The Federated Plan had five investment managers in 1987-88; by 1993-94, the Plan had 11 investment managers. Similarly, the Police and Fire Plan had five investment managers in 1987-88; by 1993-94, the Plan had 17 investment managers. As a result, the average portfolio size has declined.

TABLE 17

NUMBER OF INVESTMENT MANAGERS AND AVERAGE PORTFOLIO SIZE FROM 1987-88 TO 1993-94

	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94
Federated Plan							
Number of investment managers	5	5	5	7	8	10	11
Fund size (in millions)	$304	$339	$375	$412	$461	$512	$554
Average portfolio size per investment manager (in millions)	*$61*	*$68*	*$75*	*$59*	*$58*	*$51*	*$50*
Police and Fire Plan							
Number of investment managers	5	5	5	7	10	13	17
Fund size (in millions)	$401	$458	$513	$565	$631	$730	$806
Average portfolio size per investment manager (in millions)	*$80*	*$92*	*$103*	*$81*	*$63*	*$56*	*$47*

The proliferation of investment managers creates a tremendous amount of work for those staff members who are charged with

- Monitoring the portfolios,
- Receiving and processing quarterly performance reports and other correspondence,
- Negotiating and monitoring contracts,
- Monitoring billing and payments for services, and
- Assessing changes in staffing at the investment house.

The proliferation of investment managers also increases the costs of the investment advisors, SEI and Callan, to measure investment manager performance. Further, since most investment manager fees are calculated on a sliding scale based on portfolio size, smaller portfolios result in proportionately

higher fees. Thus, when the City reduces the average size of its portfolios, it effectively increases its administration costs. For example, using a typical fee schedule, the management fee for a $100 million portfolio would be $347,500 per year while the management fees for two separate $50 million portfolios would be $445,000 per year, or nearly $100,000 more, as shown below.

	Calculated Fees	
Fee Schedule	**$100 Million Portfolio**	**Two $50 Million Portfolios**
First $5 million at 0.75%	$37,500	$37,500 x 2 = $75,000
Next $10 million at 0.60%	60,000	60,000 x 2 = 120,000
Next $25 million at 0.40%	100,000	100,000 x 2 = 200,000
Next $60 million at 0.25%	150,000	25,000 x 2 = 50,000
Total	**$347,500**	**$445,000**

Each Retirement Fund Has Duplication In Management Styles

An important reason for contracting with several investment managers is for diversification of assets. However, we found that both retirement funds have duplication in management styles. At a recent meeting of the Police and Fire Plan retirement board, the investment advisor noted that "*Investment Advisors/Houston and Chancellor overlap in the Large Cap Growth sector*," "*Boston Company and Brinson Partners overlap in the Large Cap Value sector*," and recommended that the board look at that duplication in management styles from a fee standpoint. For example, Table 18 shows that the Police and Fire Fund has three "large cap value" managers and three "large cap growth" managers.

TABLE 18

RETIREMENT FUNDS' INVESTMENT MANAGERS AS OF JUNE 30, 1994

Asset Class	Management Style	Police and Fire	Federated
Domestic Equities	Index manager	Rhumbline	ANB
	Large cap - Value	Boston Co. Brinson Seneca	
	Large cap - Growth	Chancellor Galleon IAI Houston	Bond, Procope Chancellor
	Value (Top down)		Smoot Thompson
	Value (Bottom up)		Wilmington
	Small cap	Apodaca-Johnson	
	Small cap - growth	IAI Minnesota	Bjurman
	Mid cap growth (Top down)	Woodford	
Domestic Bonds	Active duration	Scudder	Scudder
	Short/intermediate duration	Cisneros	
	Short/income	Putnam	
	Short/government and agency	Smith, Graham & Co	
International Equities	Core equity	Baring	PCM
International Bonds	Core fixed income	Global	Putnam
Real estate	Property management	NBS	NBS

The Retirement Funds May Be Able To Pool Assets And/Or Consolidate Managers

The retirement plans could reduce the number and cost of investment managers by pooling assets and/or negotiating contracts on the combined market value of the portfolios. For example, the plans have successfully pooled their real estate investments under the guidance of one real estate manager; the one percent annual management fee is split 50/50 between the funds. In addition, both plans use Chancellor Capital Management Inc. to manage a portion of their equity portfolios; the quarterly management fee is based on the combined market value of the two portfolios.

<u>Most Equity Portfolios Use Fewer Investment Managers</u>

The investment advisor for the Police and Fire Fund recently pointed out to its board that *"The average number of managers for a $250 million equity portfolio is 5. San Jose Police & Fire has 9."* Furthermore, according to a March 1995 article in <u>Institutional Investor</u>, cost pressures are forcing pension departments to *"slim down, outsource and consolidate their external managers."*

> *Meanwhile, cost pressures are also leading funds to reduce the number of external managers they use. Leading the trend was AT&T Corp., which began trimming away external managers in the early 1980s. Since then it has cut its external managers from 112 to less than 50, who manage most of a plan that's grown to $60 billion . . ..*
>
> [In addition,] *if there are too many suppliers . . . pension funds can't find time to monitor the relationships . . ..*
>
> *As a result of a TQM effort begun in 1991, the $11.8 billion Bell Atlantic Corp. fund has pared both the number of external managers and the fee totals by 50 percent and significantly increased its use of indexing. The trend has been to consolidate money managers and consultants to deliver higher returns at comparable levels of risk in a more cost-efficient manner . . ..*

As a result of these factors, the retirement funds may be able to reduce administrative costs without impacting yields by (1) pooling assets between the funds, (2) eliminating duplication in management styles, and (3) reducing the number of investment managers.

Most Public Pension Plans Have A Larger Portion
<u>Of Their Portfolios Invested In Equity Indexes</u>

A recent nationwide survey showed that more than half of the public pension plans had more than 10 percent of their portfolios invested in equity indexes. In addition, according to an article in <u>Institutional Investor</u>,

Use of low-cost equity indexing grew 19 percent a year from 1985 through 1993 among corporate plan sponsors and an even higher 25 percent among government sponsors . . .. In all, about one quarter of the pension universe today is invested in indexed accounts . . .. These gains . . . ought to send a chill up the spine of active managers who don't consistently beat their benchmark index -- which at any given moment is roughly half the management universe.

Furthermore, the investment managers who are hired to manage the portfolios frequently end up approaching the indexes in aggregate. One reason for this is that risk is typically measured in terms of deviation from the overall market's rate of return. By indexing, the investor is assured of the market's rate of return. In that sense, indexing is less risky than assuming that one will be lucky enough or smart enough to beat the market. Nonetheless, according to Forbes magazine, pension funds spend $9 billion a year on money managers.

But, overall, active money management is a losing game. On an average day about half of the trading on the New York Stock Exchange is done by pension fund managers. Thus, increasingly, pension funds and other institutional investors are the market. By definition, the market cannot beat the market.

In the long run, the S&P 500 has outperformed the major institutional investors.

Small wonder that many institutional investors, including Exxon, Ford, American Telephone and Telegraph, Harvard University, the College Retirement Equity Funds, and the New York State Teachers Association, have put substantial portions of their assets into index funds. In 1977, $1 billion in assets were invested in index funds. By 1990, literally hundreds of billions of dollars of institutional funds were "indexed."

Moreover, the two largest California State pension plans, PERS and STRS, have indexed approximately 80 percent of their domestic equity portfolios. As of June 1993, PERS held $25.8 billion in domestic equities (33.4 percent of its portfolio) of which $20.7 billion (80 percent) was indexed.

PERS manages the indexed portion of its portfolio internally. According to its 1993 Annual Investment Report,

> *This year marked the first full 12-month period in which the internal equity portfolio was managed using the Wilshire 2500 Index as its sole benchmark. South Africa-related companies were excluded, as well as non-US.-domiciled companies, despite being traded on U.S. exchanges. This index was selected for replication because it gives the equity portfolio broad exposure to almost all capitalization sectors of the domestic economy. The portfolio comprised approximately 27 percent of all our investments and 80 percent of the domestic equity portfolio. Using indexing as a portfolio management method is advantageous because of its consistency of meeting return expectations and the ability to invest large sums very efficiently.*

The other 20 percent ($5.1 billion) of the PERS domestic equity portfolio is managed externally. According to the 1993 Annual Investment Report,

> *A separate portion of the domestic equity portfolio is managed by 18 external managers whose purpose is to achieve returns in excess of those obtained by the South Africa Free S&P 500. The selection of external managers affords the Board the opportunity to acquire portfolio management and trading expertise not available internally.*

The City's Retirement Funds Have Only 5 To 6 Percent
Of Their Domestic Equity Portfolios Under Passive Equity Management

In December 1987, the City Auditor reported that during the previous five years the retirement funds' equity managers had earned about $13 million less than the S&P 500. The City Auditor recommended that

> *The Retirement Plan Boards consider making a strategic change from active equity management to passive management for a portion of their equity portfolio. Should they conclude such a change is in the best interest of the City, they should recommend appropriate Code revisions to the City Council.*

The recommendation was adopted and implemented. In 1991-92, the Federated Plan funded American National Bank as an S&P 500 Index fund, and in 1992-93 the Police and Fire Plan funded Rhumbline to fully replicate the S&P 500.

However, as of December 31, 1994, only 5 to 6 percent of the retirement funds' domestic equity portfolios were being passively managed.

Investing In An Equity Index Fund Over The Past Ten Years Would Have Earned The Retirement Funds An Additional $72.8 Million And Saved About $10 Million In Management Fees Paid To Equity Managers

Our review revealed that in spite of hiring a total of 21 domestic equity investment managers over the past ten years, the retirement funds' domestic stock portfolios have earned substantially less than the S&P 500 Index. Since 1984-85, the Federated Plan's and the Police and Fire Plan's domestic stock portfolios have underperformed the S&P 500 by approximately $31.9 million and $5.6 million, respectively. We estimate that the cumulative cost to the retirement funds is $72.8 million in foregone earnings, assuming that foregone earnings were reinvested at the S&P 500 rate. Table 19 summarizes the performance of the equity portfolios compared to the S&P 500.

TABLE 19

COMPARISON OF DOMESTIC EQUITIES PORTFOLIO PERFORMANCE TO S&P 500 PERFORMANCE FROM 1984-85 TO 1993-94

	Market Value at Beginning of Year[12] (In millions)	Total Yield[13]	Estimated earnings at Yield Rate (In millions)	S&P 500 Index Rate	Estimated earnings at Index Rate (In millions)	Difference (In millions)	Cumulative difference (In millions)
FEDERATED							
1984-85	$ 42.0	25.6%	$ 10.8	31.0%	$13.0	($2.3)	($2.3)
1985-86	48.0	34.5%	16.6	35.8%	17.2	(0.6)	($3.7)
1986-87	76.0	8.3%	6.3	25.2%	19.2	(12.8)	($17.5)
1987-88	107.0	(7.2%)	(7.7)	(6.9%)	(7.4)	(0.3)	($16.6)
1988-89	104.0	16.9%	17.6	20.5%	21.3	(3.7)	($23.7)
1989-90	122.0	14.2%	17.3	16.4%	20.0	(2.7)	($30.3)
1990-91	141.0	6.8%	9.6	7.4%	10.4	(0.8)	($33.4)
1991-92	152.0	10.3%	15.7	13.5%	20.5	(4.9)	($42.8)
1992-93	181.0	13.1%	23.7	13.6%	24.6	(0.9)	($49.5)
1993-94	212.0	0.1%	0.2	1.4%	3.0	(2.8)	($53.0)
Subtotal	$1,185.0		$110.0		$141.8	($31.9)	($53.0)
Total gain (loss)			*9.3%*		*12.0%*	*(2.7%)*	
POLICE AND FIRE							
1984-85	$49.0	25.3%	$12.4	31.0%	$15.2	($2.8)	($2.8)
1985-86	56.0	35.0%	19.6	35.8%	20.0	(0.4)	($4.2)
1986-87	95.0	21.3%	20.2	25.2%	23.9	(3.7)	($9.0)
1987-88	135.0	(6.9%)	(9.3)	(6.9%)	(9.3)	0.0	($8.4)
1988-89	142.0	19.2%	27.3	20.5%	29.1	(1.8)	($12.0)
1989-90	167.0	14.5%	24.2	16.4%	27.4	(3.2)	($17.1)
1990-91	197.0	4.8%	9.5	7.4%	14.6	(5.1)	($23.5)
1991-92	204.0	11.2%	22.8	13.5%	27.5	(4.7)	($31.3)
1992-93	235.0	17.2%	40.4	13.6%	32.0	8.5	($27.1)
1993-94	257.0	4.4%	11.3	1.4%	3.6	7.7	($19.8)
Subtotal	$1,537.0		$178.4		$184.0	($5.6)	($19.8)
Total gain (loss)			*11.6%*		*12.0%*	*(0.4%)*	
Total	$2,722.0		$288.4		$325.9	($37.5)	($72.8)
Total gain (loss)			*10.6%*		*12.0%*	*(1.4%)*	

[12] Market value of equity portfolios taken from Retirement Program annual reports.

[13] Yields taken from SEI and Callan performance measurement reports for June 30 of each year; Police and Fire Plan equity returns for 1985-86 and 1990-91 are a weighted average of their equity manager returns for those years.

As is shown in Table 19, use of an indexed fund would have generated an additional $53 million for the Federated Fund and $19.8 million for the Police and Fire Fund over the last ten years--a total of $72.8 million in foregone earnings for both funds.

In addition to the foregone earnings shown in Table 19, we have estimated that the retirement funds would have saved up to $10.5 million in equity manager fees over the same ten-year period if both funds' equity portfolios had been invested in index funds as shown below.

TABLE 20

FEDERATED FUND AND POLICE AND FIRE FUND
EQUITY MANAGER FEE SAVINGS OVER TEN YEARS

	Federated	Police and Fire	Total
Total equity portfolios over last 10 years	$1,185,000,000	$1,537,000,000	$2,722,000,000
Estimated active management fee*	0.33%	0.52%	
Estimated fee	**$3,910,500**	**$7,992,400**	**$11,902,900**
Estimated index management fee*	0.05%	0.05%	
Estimated fee	**$592,500**	**$768,500**	**$1,361,000**
Difference	*($3,318,000)*	*($7,223,900)*	*($10,541,900)*

* Estimated fee rates based on 1994-95 equity manager fee schedules.

Our estimate of saved equity manager fees is based upon current fee schedules applied retroactively against the total market value of equity investments over the last ten years. It should be noted that given the uncertainty as to when the estimated equity management fees shown above would have been paid over the last ten years, we did not assume that saved equity manager fees would be reinvested to generate additional investment income. By so doing, we have conservatively stated the impact to the funds of paying equity management fees.

Additional Earnings And Fee Savings Would Have Improved
Upon The Funded Status Of Both Retirement Plans As Of June 30, 1993

Investing in an index fund from 1984-85 through 1993-94 would have improved upon the funded status of both retirement plans. Specifically, as of June 30, 1993, the Federated Plan and Police and Fire Plan were funded as follows:

TABLE 21

FUNDED STATUS OF RETIREMENT PLANS AS OF JUNE 30, 1993

	Federated	Police and Fire	Total
Net assets available for benefits	$512,210,000	$730,149,000	$1,242,359,000
Pension benefit obligation	629,713,000	719,519,000	1,349,232,000
Funded (Unfunded)	*($117,503,000)*	*$10,630,000*	*($106,873,000)*
Funded status	*81.3%*	*101.5%*	*92.1%*

From 1984-85 through 1992-93, we estimate that cumulative increased earnings and fee savings from using an index fund would have been $52 million for the Federated Plan and $33 million for the Police and Fire Plan. As a result, the use of an index fund would have improved the funded position of both plans by an indeterminate, albeit substantial, percentage as of June 30, 1993. The exact percentage improvement in funding for the two plans cannot be estimated accurately given the cost basis methodology[14] used to estimate the "net assets available for benefits" shown above in Table 21.

---

[14] Investments in debt securities are recorded at cost, adjusted for the amortization of premiums and discounts (the difference between purchase cost and maturity value), over the remaining life of the issue using a method which approximates the effective interest method, subject to adjustment for market declines judged to be other than temporary. Investments in equity securities are recorded at cost, subject to adjustment for market declines judged to be other than temporary. Gains or losses on investment securities are recognized as of the trade date on a weighted average cost basis. Investment income is recognized as earned. Investments in real estate are stated at cost less accumulated depreciation, calculated on a straight-line basis over the useful lives of the related property improvements. Rental income is recognized as earned, net of expenses. [**Source:** Annual audited financial statements].

The Retirement Funds Could Earn Up To $7.1 Million Annually
By Indexing Their Domestic Stock Portfolios

The retirement plans held $508.1 million in domestic equities as of December 31, 1994. As shown in Table 19, the equity portfolios have underperformed the S&P 500 by 1.4 percent over the past ten years. Specifically, the Federated Plan's and Police and Fire Plan's equity portfolios earned 2.7 percent less and 0.4 percent less than the S&P 500, respectively. If that trend were to continue, the equity portfolios could earn up to 1.4 percent, or $7.1 million more per year, if they were indexed.

Federated Plan (2.7 percent of $222.3 million)	$6.0 million
Police and Fire Plan (0.4 percent of $285.8 million)	1.1 million
Total	$7.1 million

It should be noted that for purposes of calculating the additional earnings the retirement funds would have earned by indexing, we used the actual annual rates of return. By so doing, our estimate of additional earnings is conservative. For example, had we used another acceptable method, such as average rate of return, our estimate would have been substantially higher.

The Retirement Funds Could Save Up To $1.9 Million Annually
In Management Fees By Indexing Their Domestic Stock Portfolios

In addition to increased earnings, the retirement funds could dramatically reduce their management fees by indexing their domestic stock portfolios. The Federated Plan's and the Police and Fire Plan's domestic stock portfolios are 95 and 94 percent actively managed, respectively. Generally speaking, active management is more expensive than passive or indexed portfolio management. In fact, STRS estimates that active management of its domestic equity

portfolio costs 20 times more than passive management. The difference in costs for the City, though not as extreme, is still dramatic. For example, as of December 31, 1994, American National Bank was managing a $12 million portfolio for the Federated Plan for approximately $15,000 per year, while Bjurman (one of the six active domestic equity managers) was managing a $14.7 million portfolio for approximately $132,000 per year. Thus, American National Bank was charging approximately 13 basis points per year (0.13 percent of assets) and Bjurman was charging approximately 90 basis points per year (0.90 percent of assets). In 1994, the American National Bank portfolio yielded 1.37 percent; the Bjurman portfolio showed a loss of 8.18 percent. The reason for paying for active managers is to beat the market; however, in this case, the additional cost did not yield additional income.

We have estimated the potential fee savings from increased use of domestic stock index managers. The two retirement funds pay approximately $2.1 million per year in domestic equity management fees. As Table 22 shows, we estimate that the retirement funds could save up to $1.9 million annually by indexing their domestic stock portfolios.

TABLE 22

ESTIMATED FEE SAVINGS FROM INCREASED USE OF DOMESTIC STOCK INDEX MANAGERS BASED ON PORTFOLIO MARKET VALUE AS OF DECEMBER 31, 1994

Federated Plan Domestic Stock Portfolio					
Proportion indexed	5%	25%	50%	80%	100%
Actively managed portfolio	$210,300,000	$166,725,000	$111,150,000	$44,460,000	$0
Indexed portfolio	12,000,000	55,575,000	111,150,000	177,840,000	222,300,000
	$222,300,000	$222,300,000	$222,300,000	$222,300,000	$222,300,000
Estimated active management fee[15]	0.33%	0.33%	0.33%	0.33%	0.33%
Estimated index management fee[16]	0.10%	0.07%	0.05%	0.04%	0.03%
Estimated total annual fees	$696,844	$582,209	$414,550	$207,920	$70,167
Estimated annual savings		*$114,635*	*$282,294*	*$488,924*	*$626,677*
Police and Fire Plan Domestic Stock Portfolio					
Proportion indexed	6%	25%	50%	80%	100%
Actively managed portfolio	$268,100,000	$214,350,000	$142,900,000	$57,160,000	$0
Indexed portfolio	17,700,000	71,450,000	142,900,000	228,640,000	285,800,000
	$285,800,000	$285,800,000	$285,800,000	$285,800,000	$285,800,000
Estimated active management fee[15]	0.52%	0.52%	0.52%	0.52%	0.52%
Estimated index management fee[16]	0.07%	0.05%	0.05%	0.04%	0.04%
Estimated total annual fees	$1,405,285	$1,153,501	$812,059	$399,900	$124,175
Estimated annual savings		*$251,784*	*$593,226*	*$1,005,386*	*$1,281,110*
Combined total annual fees	*$2,102,129*	*$1,735,710*	*$1,226,609*	*$607,820*	*$194,342*
Combined estimated annual savings		*$366,419*	*$875,520*	*$1,494,309*	*$1,907,787*

15 Estimated active management fee rates as of June 30, 1994. Percentages have been rounded for presentation purposes.

16 Estimated index management fees are based on current contracts with ANB (Federated Plan) and Rhumbline (Police and Fire Plan). Percentages have been rounded for presentation purposes.

Brokerage Costs

It should also be noted that index managers typically do less trading of equities; as a result, their brokerage or commission costs are less. We estimate that the funds are incurring approximately $800,000 per year in commissions. However, these brokerage fees are paid from the investment manager accounts; they are not billed separately to the retirement plans. As a result, brokerage costs are reflected in the reduced yields of the active equity managers. In other words, investment manager yields are net of brokerage costs but not net of management fees.

CONCLUSION

The $1.4 billion portfolios of the Federated Employees' Retirement Fund and Police and Fire Department Retirement Fund are managed by a large number of external investment management teams. Our review revealed that the majority of investment managers have underperformed the performance objectives outlined in the retirement funds' investment policies and that the retirement plans do not have a formal probationary process for investment managers. In addition, only one manager is paid a performance-based fee. Furthermore, most public pension plans have a larger portion of their equity portfolios indexed than the city of San Jose's 5 to 6 percent. Finally, our analysis shows that over the past ten years, if the plans' equity portfolios had been invested in an equity index fund instead of with the variety of managers who were used, the plans could have earned about $72.8 million more and saved about $10 million in management fees. These additional earnings and fee savings would have improved upon the funded status of both retirement plans. Based on the past ten years' earnings, we estimate that the plans may be able to earn up to $7.1 million more per year and reduce investment management fees by up to $1.9 million per year if they index their equity portfolios.

RECOMMENDATIONS

We recommend that the Federated Employees' Retirement System and the Police and Fire Department Retirement Plan:

Recommendation #1:

Establish probationary procedures including:

- A process for placement on a formal watch list and subsequent probation when a manager's performance falls below applicable standards and
- Procedures for reporting underperformance of investment manager benchmarks on a quarterly and annual basis that call attention to managers that are not in compliance with investment performance objectives.

(Priority 2)

Recommendation #2:

Revise the standard language in investment manager, advisor, and/or custodian bank contracts to include (1) benchmark performance standards, (2) a process for dealing with underperformance, (3) timeliness requirements for reporting, and (4) reference to the City Council's Policy #0-15 (the code of ethics). (Priority 2)

Recommendation #3:

Review the experience qualifications that are specified in the San Jose Municipal Code for investment managers and either propose changes to the Code or ensure that investment managers are in compliance. (Priority 2)

Recommendation #4:

Negotiate performance-based fee structures as investment manager contracts become due. (Priority 2)

Recommendation #5:

Reduce the number of investment managers and decrease investment fees by

- Increasing use of index funds;
- Avoiding duplicative management styles; and
- Pooling investments in certain asset classes between the two retirement funds.

(Priority 1)

Recommendation #6:

Establish a phased program to transfer substantial portions of the domestic equity portfolios of the two retirement plans to index managers. (Priority 1)

FINDING II

OPPORTUNITIES EXIST TO ENHANCE THE RETIREMENT BOARDS' ABILITY TO ASSESS THE STATUS OF THE INVESTMENT PORTFOLIOS

The San Jose Municipal Code requires monthly reporting of short- and long-term retirement fund investments. However, our review revealed that the funds' monthly investment reports are not issued in a timely manner and that millions of dollars in short-term retirement fund investments are not included in the monthly investment transaction resolutions. Moreover, in spite of the fact that asset allocation decisions determine investment performance and have potential multi-million-dollar effects on investment earnings, the Federated Employees' Retirement System's (Federated Plan) and the Police and Fire Department Retirement Plan's (Police and Fire Plan) asset allocations and investment policies were not comprehensively reviewed for several years. In our opinion, the respective boards of administration should improve the timeliness and completeness of reporting on the status of the investment portfolios and establish procedures to annually review investment policies and asset allocation strategies.

The San Jose Municipal Code Requires Monthly Reporting Of Short- And Long-Term Retirement Fund Investments

San Jose Municipal Code, section 3.24.360, enables the Federated Plan's board to delegate authority to make investments. It also requires monthly reporting of transactions.

3.24.360 Investment of funds -- Delegation of authority.

Without limiting the authority of the board itself to invest and reinvest the moneys of the retirement fund as provided in Section 3.24.350, the board

may adopt an investment resolution or resolutions containing detailed guidelines, consistent with Section 3.24.350, by which to designate investments which are acceptable for purchase. While the resolution or resolutions are in effect, investments consistent with such guidelines may be made by an officer of the board, an officer or employee of the city, or a qualified investment advisory who has entered into a contractual arrangement pursuant to Section 3.24.370, provided that such officer, employee or advisor has been delegated such authority by the board and such officer, employee or advisor has been designated by name in the investment resolution or resolutions. <u>Any transactions made pursuant to the foregoing provisions of this section shall be reported monthly to the board by the person or persons to whom the board has delegated such authority</u>. [Emphasis added.]

Similarly, Code section 3.36.530 enables the Police and Fire Plan's board to delegate authority to make investments. It contains more detailed instructions regarding monthly reporting.

3.36.530 Investment of funds--Delegation of authority.

A. Without limiting the authority of the board itself to invest and reinvest the moneys of the retirement fund as provided in Section 3.36.540, the board may adopt an investment resolution or resolutions containing detailed guidelines, consistent with Section 3.36.540, by which to designate investments which are acceptable for purchase. While the resolution or resolutions are in effect, investments consistent with such guidelines may be made by an officer of the board, an officer or employee of the city, or a qualified investment advisor who has entered into a contractual arrangement pursuant to Section 3.36.560, provided that such officer, employee or advisor has been delegated such authority by the board and such officer, employee or advisor has been designated by name in the investment resolution or resolutions. <u>Any transactions made pursuant to the foregoing provisions of this section shall be reported to the board at its next regular meeting.</u>

B. Without limiting the authority of the board itself to invest and reinvest the moneys in the retirement fund as provided in Section 3.36.540 or to delegate authority for investment and reinvestment as provided in subsection A of this section, the board may, by resolution, designate a person by name to make short-term investments and reinvestments of moneys in the retirement fund and to purchase, sell, or exchange such short-term investments and reinvestments of moneys in the retirement fund and to purchase, sell, or exchange such short-term investments. For

purposes of this subsection, "short-term investments" shall consist of the following:

1. *Repurchase agreements and reverse repurchase agreements;*
2. *Short-term investment fund;*
3. *Investments which are in commercial paper, United States Treasury bills, bankers' acceptances, negotiable certificates of deposit, or similar evidences of indebtedness; and*
   a. *Which are of no more than one year in duration; and*
   b. *Which are liquid in nature; and*
   c. *Which are not investments in bonds or preferred or common stock.*

The person to be so designated by the board shall be either a member of the board, a qualified investment advisor who has entered into a contractual arrangement pursuant to Section 3.36.560, or an officer or employee of the city. <u>The person so designated shall serve in said capacity at the pleasure of the board and shall report monthly to the board on such short-term investments.</u> [Emphasis added.]

<u>*Reporting Guidelines Recommended By State Task Force*</u>

As a result of the Orange County investment loss, the California State Legislature established a Task Force on Local and State Investment Practices. On March 14, 1995, the Task Force issued a report on possible investment guidelines for county, city, and other local agency accounts which included the following:

Recommendation 1: Amend state law to require each local treasurer or chief fiscal officer to provide annually a written statement of investment policy to the legislative body of the local agency for its consideration at a public meeting, and to submit a report no less frequently than quarterly to the legislative body and their chief executive officer containing a detailed description of the local agency's investment securities, including current market values . . .. The quarterly reports would be required (i) to be submitted to the legislative body <u>within 30 days of the quarter's end</u>, (ii) to contain a statement with respect to compliance with the written annual statement of investment policy, and (iii) to be made available to taxpayers upon request for a nominal charge. [Emphasis added.]

The report continues:

The Task Force requirement that the quarterly reports be submitted to the local agency legislative body within 30 days of the quarter's end is to ensure that the reporting occurs on a regular and timely basis.

The reason the Task Force gave for mandating quarterly (rather than monthly) reports was to avoid increasing local agency costs as the result of a state legislative mandate. Evidently,

Legislation adopted ten years ago (after San Jose suffered big investment losses) required treasurers to report monthly to local officials about their investments. This law contained a "sunset clause" and expired in 1991.

The Task Force focused on the issue of frequent and prompt disclosure--the Orange County treasurer *"filed reports with the county supervisors just once a year."* The media has noted this lesson. According to an article in Money magazine, the lesson to be learned from the Orange County losses is that *"clearly government managers should be required to calculate the value of their holdings at least monthly."*

Monthly Investment Reports Are Not Issued In A Timely Manner

The retirement boards receive several types of monthly investment reports. The custodian banks (Bankers' Trust for the Police and Fire Plan and Bank of New York for the Federated Plan) prepare monthly resolutions for board approval of investment and reinvestment transactions. However, our review revealed that these resolution reports are not issued in a timely manner. For example, the resolution detailing investment activity in the Police and Fire Fund from July 1 to 31, 1994, was not presented to the Police and Fire Plan retirement board until March 2, 1995--seven months after the fact. We also found that as of June 1995, the Federated Fund's custodian bank had not prepared any of the

necessary resolution reports for Federated Plan investment transactions since it took over custodianship of the account in July 1994--one year earlier.

The Treasury Division of the Finance Department prepares a monthly summary, the Report of Retirement Plan Investments, for retirement board review. Our review revealed that these reports are not issued in a timely manner either. For example, at its March 9, 1995, meeting, the Federated Plan retirement board accepted the reports of Federated Plan investments for July through October 1994--from four to seven months after the fact. Table 23 summarizes the board meeting dates where these two types of investment reports were finally presented.

TABLE 23

MONTHLY MEETING DATES WHEN MONTHLY INVESTMENT REPORTS AND MONTHLY INVESTMENT TRANSACTION RESOLUTIONS FOR 1994-95 WERE PRESENTED TO THE RETIREMENT BOARDS THROUGH JUNE 1995

Activity Period	Federated Plan Monthly Summary Report Of Investments (Prepared By Treasury)	Federated Plan Monthly Investment Transaction Resolutions (Prepared By Custodian Bank)	Police and Fire Plan Monthly Summary Report Of Investments (Prepared By Treasury)	Police and Fire Plan Monthly Investment Transaction Resolutions (Prepared By Custodian Bank)
July 1994	3/9/95	None	1/5/95	3/2/95
August 1994	3/9/95	None	2/2/95	3/2/95
September 1994	3/9/95	None	2/2/95	3/2/95
October 1994	3/9/95	None	3/2/95	2/2/95
November 1994	4/13/95	None	5/4/95	3/2/95
December 1994	5/11/95	None	5/4/95	3/2/95
January 1995	6/8/95	None	5/4/95	4/6/95
February 1995	None	None	5/4/95	6/1/95
March 1995	None	None	6/1/95	None
April 1995	None	None	None	None
May 1995	None	None	None	None
June 1995	None	None	None	None

The Role Of The Custodian Banks

The process of preparing monthly financial reports for retirement board review begins with the custodian banks. It is standard industry practice for a pension fund's custodian bank to prepare the monthly valuation of assets. The Police and Fire Plan's contract with Bankers' Trust specifies a variety of reports that shall be produced including monthly and annual reports, but it does not specify timeliness requirements. The Federated Plan's contract with the Bank of New York also specifies a variety of reports that shall be produced, including a year-end listing of assets as of June 30 that is to be produced by July 31. The contract does not specify a timeliness requirement for the monthly reports. The other timeliness requirement in the Bank of New York contract is for annual and semi-annual reports on broker commissions paid. For example, the semi-annual report of broker commissions paid from July 1, 1994, through December 31, 1994, was due on January 31, 1995. The Bank of New York did not present this report until the fourth week of April 1995--nearly three months late.

The Finance Department Issues The City's Investment Reports In A More Timely Manner

The city of San Jose's (City) Finance Department prepares monthly investment reports for the Pooled Investment Funds that contain a valuable three- to four-page executive summary prepared by Finance Department staff. Its succinct management summary provides a clear picture of

- The status of the current investment portfolio,
- Exceptions to the investment policy, and
- Significant transactions during the past month.

These monthly reports are issued two to three weeks after month-end and heard at the next Finance Committee meeting (from four to six weeks after month-end).

The Investment Portfolios Include Substantial Amounts Of Short-Term Cash And Equivalents That Are Not Included In The Monthly Investment Transaction Resolutions

While the retirement boards eventually receive a monthly listing of securities transactions (the custodian banks prepare the resolutions), they do not receive a transaction report for short-term investments. As Table 24 shows, in October and November 1994, the cash portions of the Federated Plan's and Police and Fire Plan's portfolios were 4.2 percent and 9.9 percent, respectively.

TABLE 24

CASH POSITIONS OF INVESTMENT MANAGERS BY ASSET CLASS

	Federated Plan (As Of 10/31/94)	*Cash Portion Of Managers' Portfolio*	Police and Fire Plan (As Of 11/15/94)	*Cash Portion Of Managers' Portfolio*
Domestic equity managers	$13.3	*6.4%*	$13.0	*4.5%*
International equity managers	1.0	*3.5%*	4.1	*7.0%*
Domestic fixed income managers	5.0	*2.0%*	48.3	*12.6%*
International fixed income managers	0.4	*1.7%*	6.9	*13.3%*
Real estate manager	4.0	*8.6%*	9.6	*20.6%*
Total	$23.7	*4.2%*	$81.9	*9.9%*

Source: Retirement Program

Our review revealed that the short-term investment transactions comprising these cash positions are not included on the monthly investment resolutions that the custodian banks prepare. These assets are summarized in the monthly investment summary the Finance Department prepares, but without details. For example, the monthly report for September 1994 lists the market value of the

Police and Fire Plan's short-term investments at $73.1 million and lists interest income (September 1 to 30) from short-term instruments of $210,000. Our review revealed that the monthly transaction resolution for September 1994 did not include transaction details for eight purchases of short-term corporate notes totaling $34 million. Furthermore, neither report listed movement of cash through the custodian bank's cash fund. For example, the bank statement for September 1994 shows 106 purchases totaling $12.7 million and 51 sales totaling $17.5 million in the Bankers' Trust Pyramid Government Securities Cash Fund that were not reported on the monthly investment transaction resolution for September 1994.

On a quarterly basis, the investment manager performance reports usually show a line-item market value total of cash and equivalents as of the end of the quarter. Some managers show the yield; some do not. These reports do not typically report transactions related to the handling of cash, cash equivalents, or other short-term investments. As a result of this exclusion, transaction details for up to 10 percent of the investment portfolios are not formally reported to the retirement boards.

Investment Policies And Asset Allocation Strategies Are Not Regularly Reviewed

It has been several years since the retirement boards formally reviewed and revised their investment policies and asset allocation strategies. Both retirement boards are currently reviewing their asset allocation strategies with the assistance of their investment advisors. The asset allocation decisions the boards make during these reviews will have a dramatic effect on future earnings in the two retirement funds.

Asset Allocation Decisions Determine Investment Performance

According to the Pennsylvania-based SEI Capital Resources Market Research Group,

> *The asset allocation decision (how a plan's investment is divided among different asset classes) exercises by far the largest impact on overall performance. Analysis of U.S. pension plan performance shows that the asset allocation decision alone explains 91.5% of the variation in a plan's performance, making it significantly more important than industry weighting, stock selection, market timing, or any other portfolio management decisions.*

Thus, according to experts, probably the most important decision fiduciaries can make is asset allocation while other decisions pale in comparison. Nonetheless, our review found that neither of the retirement boards formally reviewed asset allocation on a regular basis.

Strategic Asset Allocation Decisions Can Have Multi-Million-Dollar Effects

Strategic asset allocation decisions can have multi-million-dollar effects on future required contributions. For example, according to a recent SEI report to the Police and Fire Plan retirement board, 91.5 percent of the total return variation between various pension funds was explained by the funds' asset allocation; only 1.7 percent of the variation was explained by market timing; only 4.6 percent was explained by stock selection; 2.1 percent was explained by other factors. Furthermore, from 1900 to 1993, an investor's market timing would had to have been 75 percent accurate in order to beat a buy and hold strategy (which would have generated average annual returns of 9.4 percent per year).

The SEI presentation compared several potential allocation options for the Police and Fire Fund, at the same time making the point that retirement plans

usually look at a 50-year time horizon. Based on the Police and Fire Plan's current target asset allocation, SEI would expect an average annual rate of return of 8.6 percent, with a 25 percent chance of exceeding 17.1 percent and a 25 percent chance of being below 0.8 percent. As can be seen in Table 25, expected rates of return increase as (1) the proportion of equities increases, (2) with the addition of small capitalization stocks, and/or (3) with the addition of emerging market investments. The retirement boards' task is to weigh the rewards of probable higher rates of return in the long run against higher risks, especially in the short term.

TABLE 25

ALTERNATIVE ASSET ALLOCATION POLICIES PRESENTED TO POLICE AND FIRE PLAN RETIREMENT BOARD BY SEI CONSULTANTS

	Option A	Current Option B	Option C	Option D	Option E
Allocation Of Assets					
Cash	6%	0%	0%	0%	0%
Bonds	53%	45%	30%	30%	30%
Stocks - large	30%	35%	40%	50%	30%
Stocks - international	6%	10%	15%	15%	18%
Stocks - small	0%	0%	0%	0%	10%
Real estate	5%	10%	15%	5%	5%
Emerging markets	0%	0%	0%	0%	7%
Total	100%	100%	100%	100%	100%
Expected Yields					
Expected rate of return	8.0%	8.6%	9.2%	9.4%	9.9%
25% chance that rate of return will exceed...	15.1%	17.1%	19.1%	20.5%	21.1%
25% chance that rate of return will be less than...	1.4%	0.8%	0%	(0.6)%	(0.3)%
Probable Value Of Assets					
Probable value of assets	$ 1,537	$ 1,611	$ 1,679	$ 1,712	$ 1,781
25% chance that assets will exceed...	$ 1,787	$ 1,949	$ 2,130	$ 2,255	$ 2,375
25% chance that assets will be less than...	$ 1,332	$ 1,350	$ 1,350	$ 1,348	$ 1,386

Source: SEI Asset Allocation And Manager Structure Review (November 18, 1994)

As Table 25 shows, the implications over a ten-year period are enormous. Specifically, under the current asset allocation policy (Option B), SEI estimates that the probable value of assets would be $1.611 billion (with a 25 percent chance of exceeding $1.949 billion and a 25 percent chance that assets will be less than $1.350 billion). Option D increases the probable value of plan assets to $1.712 billion (with a 25 percent chance of exceeding $2.255 billion) without significantly increasing the risk that assets will be valued at less than $1.348 billion after ten years. Conversely, Option A (increasing the allocation to bonds and cash) decreases the probable value of assets to $1.537 billion.

The Retirement Plans' Asset Allocation Strategies
Are Similar To Other Jurisdictions' Strategies

Our review of the retirement plans' asset allocation strategies revealed that they are not dissimilar to other California city retirement systems' strategies. For example, a recent asset allocation study shows that San Jose's retirement investments, like those of other city respondents, are weighted towards bonds while state and county respondents' investments are weighted toward stocks. Table 26 shows the results of the survey.

TABLE 26

ASSET ALLOCATION SURVEY OF CALIFORNIA RETIREMENT SYSTEMS COMPARED TO SAN JOSE'S RETIREMENT SYSTEMS AS OF JUNE 30, 1993

	State Plans	County Plans	City Plans	Total Respondents	*San Jose Federated Plan*	*San Jose Police and Fire Plan*
Domestic stocks	49.7%	42.8%	38.8%	42.4%	*37.6%*	*32.3%*
Domestic bonds	33.5%	36.6%	46.2%	39.0%	*47.8%*	*51.1%*
International	9.5%	10.2%	7.6%	9.4%	*6.7%*	*11.0%*
Real Estate	3.4%	5.1%	3.9%	4.6%	*7.9%*	*5.7%*
Other	2.6%	2.3%	0.3%	1.7%	*0.0%*	*0.0%*
Cash*	1.3%	3.0%	3.3%	2.9%	*0.0%*	*0.0%*
Total	100.0%	100.0%	100.0%	100.0%	*100.0%*	*100.0%*

* Neither of the City's retirement boards allocate assets to cash; however, as shown in Tables 24 and 27, various investment managers hold cash.

Another study, comparing funds with assets from $500 million to $1 billion, also shows the City is weighting its strategy towards bonds, while other funds are weighting toward stocks. Table 27 shows this comparison.

TABLE 27

ASSET ALLOCATION STUDY OF FUNDS WITH ASSETS FROM $500 MILLION TO $1 BILLION AS OF JUNE 30, 1994

	Domestic Equity	Interna-tional Equity	Fixed Income	Interna-tional Fixed	Cash and Equivalents	Real Estate	Other
San Jose Police and Fire Plan	36.1	8.5	39.7	5.1	6.1	4.4	0.0
San Jose Federated Plan	35.1	4.8	45.2	3.9	4.5	6.4	0.0
Weighted average of respondent funds with assets from $500 million to $1 billion	43.0	10.0	34.4	3.8	3.2	3.7	1.9
Weighted average of all respondents	43.1	8.2	36.9	2.8	2.7	3.6	2.8

The City's Investment Policy And Internal Investment Committee

The Finance Department reports exceptions to the City's investment policy monthly and summarizes any exceptions in its monthly investment report. In addition, brokers must annually sign that they have read and understood the policy. Furthermore, the City uses an internal investment committee to annually review the investment policy, strategy, and holdings and render advice as appropriate.

The City's investment policy outlines the composition and functions of an internal investment committee. Specifically,

> *There shall be an Internal Investment Committee consisting of the City Manager, the Director of Finance, the Deputy Director of Finance (Treasury), the Deputy Director of Finance (Accounting), and three private sector investment experts named by the Mayor. The Committee shall meet at least quarterly to discuss the Monthly Investment Reports, investment strategy, investment and banking procedures and significant investment-related work projects being undertaken in the Finance Department. The Committee's meetings will be summarized in minutes which are distributed to the City Council.*

The members of the City's Internal Investment Committee include a banking representative from a local bank (San Jose National Bank), an economist from San Jose State University, and a certified public accountant from a local firm. According to one City Council member, their volunteer service to the City provides "solace" to City Council members who may not be expert in investment matters.

Liquidity Requirements Are Changing

An annual review of the retirement funds' investment policies would help ensure that they address current issues. For example, in the past the retirement

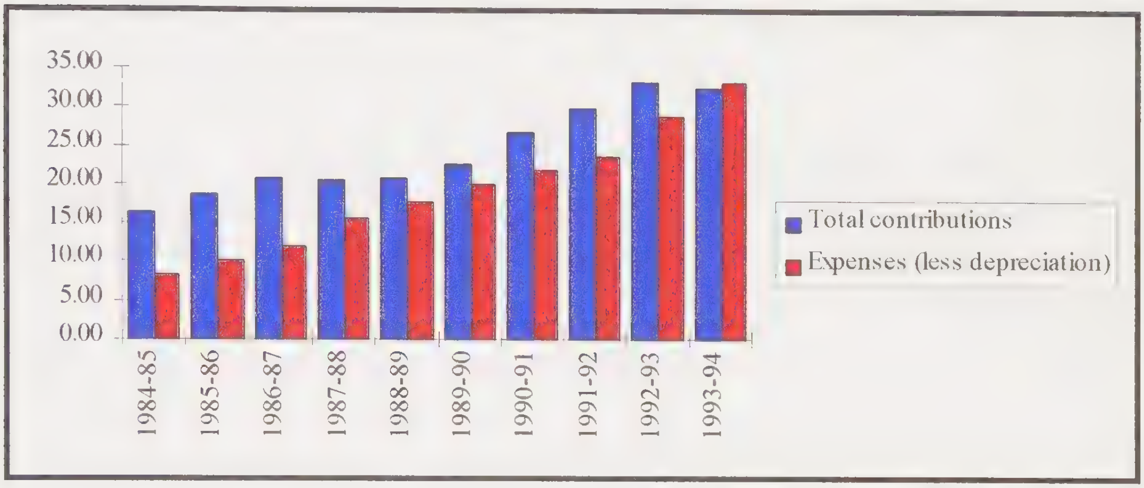
plans did not need to maintain significant liquid reserves for the payment of pension benefits. In fact, the Police and Fire Plan's investment policy includes the following statement on liquidity (the Federated Plan's investment policy does not have a statement on liquidity):

> *Presently there is not a requirement to maintain significant liquid reserves for the payment of pension benefits. The Board has authorized the Board of Administration Secretary to review the projected cash flow requirements at least annually and indicate to investment managers the required liquidity. Contributions are expected to be in excess of net benefit payments over the foreseeable future, resulting in a positive cash flow, which will be reinvested by the fund manager who receives the cash flow.*

However, this situation is changing in that total Federated Plan contributions were less than expenses during 1993-94 (Graph 6). Further, recent trends indicate that expenses may also exceed contributions for the Police and Fire Fund in the near future (Graph 7). In our opinion, the Federated Plan's retirement board should include a liquidity statement in its investment policy. In addition, both retirement plan boards should annually review cash flow requirements and transfer cash held in various investment managers' portfolios as needed to cover the difference between expenses and contributions.

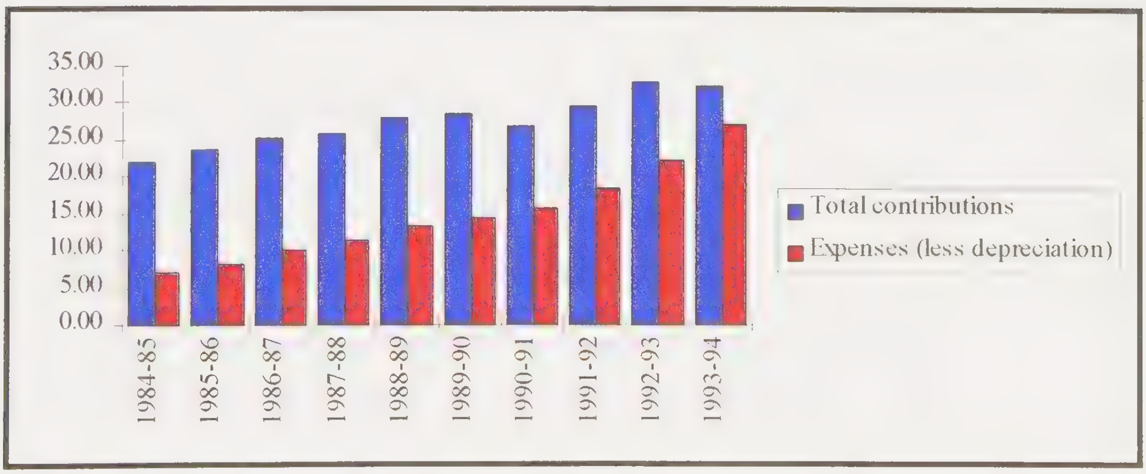
GRAPH 6

FEDERATED PLAN TOTAL CONTRIBUTIONS AND EXPENSES
FOR 1984-85 THROUGH 1993-94
(In Millions)



GRAPH 7

POLICE AND FIRE PLAN TOTAL CONTRIBUTIONS AND EXPENSES
FOR 1984-85 THROUGH 1993-94
(In Millions)



Comparison To Other Pension Plans' Investment Policies

Our review of the investment policies of five comparable California city and county pension plans revealed several other interesting provisions that the retirement boards may want to consider incorporating into their investment policies:

- San Joaquin County requires the retirement administrator to review projected cash flow requirements with the retirement board on at least an annual basis and includes provisions for formal manager reviews;
- City of San Diego prohibits leveraging and includes specific provisions to handle deficient manager performance (see Finding I); and
- City of Fresno prohibits churning and market timing strategies.

The City's Investment Policy Specifies Safety As Its Number One Goal;
The City's Retirement Plans Have Other Goals

The City's investment policy clearly specifies the three basic objectives of San Jose's investment program. In order of priority,

(1) Safety of invested funds;

(2) Maintenance of sufficient liquidity to meet cash flow needs; and,

(3) Attainment of the maximum yield possible consistent with the first two objectives.

The policy establishes detailed reporting criteria including

Reasons for and amounts of violations or exceptions to the investment policy during the month being reported on, as well as prior violations or exceptions which have not yet been corrected.

The retirement fund investment guidelines specify different objectives. Specifically, the retirement boards shall:

(1) Require that the Retirement System be sufficiently funded to assure that all disbursement obligations will be met.

(2) Attempt to insure that investment earnings be sufficiently high to provide a funding source, along with contributions from City employees and the City, in order to offset liabilities in perpetuity.

(3) Strive for the highest total return on investment funds consistent with safety in accordance with accepted investment practices.

Thus, there is a significant difference between the investment policies for the City's retirement funds and the investment policies for the City's Pooled Investment Funds. In our opinion, the retirement boards and the City Council should periodically review and discuss this difference to ensure a clear understanding of and agreement on the difference.

The Municipal Code Should Be Updated

According to San Jose Municipal Code, section 3.36.520,

> *All payments from the* [Police and Fire] *fund shall be made upon warrants drawn by the city auditor upon demands made by the retirement board.*

The City Auditor is not involved in Police and Fire Fund disbursements. Therefore, it is the City Auditor's opinion that the City Council should modify the language in the Municipal Code to coincide with section 3.24.320 regarding the Federated Plan which states that

> *All payments from the* [Federated] *fund shall be made upon warrants drawn in the manner required for the disbursement of other public funds, but only upon authorization of the board.*

CONCLUSION

Our review revealed that retirement fund monthly reports are not in compliance with San Jose Municipal Code requirements regarding timeliness and completeness. In addition, the retirement boards should review on an annual basis the retirement plans' investment policies and asset allocation strategies.

RECOMMENDATIONS

We recommend that the Retirement Program:

Recommendation #7:

Prepare monthly investment reports similar in scope to the Finance Department's Monthly Investment Report. The executive summary should include significant developments; market overview; portfolio mix and yields; exceptions and violations of the investment policy; description of unrealized losses and gains; comparison to budget; and future commitments and cash management projections. (Priority 2)

Recommendation #8:

Clarify and enforce custodian bank timeliness requirements for reporting. (Priority 2)

In addition, we recommend that the boards of administration for the retirement plans:

Recommendation #9:

Establish a process to annually review their asset allocation strategies. This review should include a comparison to other public pension funds. (Priority 1)

Recommendation #10:

Establish internal investment committees to advise the boards of administration of the retirement plans on asset allocation strategies and investment policy changes. The committees should include retirement staff, private and public sector investment experts, and City Finance Department/Administration representatives. (Priority 2)

Recommendation #11:

Establish a process to annually review the investment policies for the respective retirement funds and distribute updated copies of the policies to investment managers and advisors annually. (Priority 2)

Recommendation #12:

The Federated Employees' Retirement System's board should include a liquidity statement in its investment policy. Both boards should establish procedures requiring an annual review of their cash flow requirements. (Priority 2)

Also, we recommend that the City Attorney:

Recommendation #13:

Draft an amendment to the San Jose Municipal Code for City Council approval to delete references to the City Auditor in Municipal Code section 3.36.520 regarding warrants drawn on the Police and Fire Retirement Fund. (Priority 3)

FINDING III

CHARGING THE RETIREMENT PLANS FOR SERVICES THE FINANCE DEPARTMENT PROVIDES WOULD REDUCE GENERAL FUND EXPENDITURES BY $61,000 PER YEAR AND POOLED INVESTMENT FUND EXPENSES BY $11,000 PER YEAR

The Finance Department provides certain unreimbursed accounting services to the retirement funds. The General Fund and the Pooled Investment Funds absorb the cost of these activities. By charging the retirement plans for these costs, the General Fund would save about $61,000 per year and the Pooled Investment Funds would save about $11,000 per year.

The Finance Department Provides Unreimbursed Services To The Retirement Funds

Our review revealed that the Finance Department provides significant accounting and reporting functions to the retirement plans without reimbursement. Specifically, the Accounting Division

- Receives monthly reports from the custodian banks and records investment income in the City's Financial Management System (Retirement Program staff handles rent receipts);
- Initiates the wire transfers to and from the custodian banks depositing employee and employer contributions and requesting reimbursement for retiree payroll and expenses;
- Updates employee reserve accounts when an employee retires or leaves;
- Performs reconciliations related to these items; and
- Prepares draft financial statements for the retirement plans at year-end.

These functions are performed by an accountant II (1.0 FTE) with part-time help from an accounting technician. They are paid from the General Fund.

In addition, the Treasury Division

- Summarizes monthly reports from the custodian banks and produces the monthly Report of Retirement Plan Investments for the retirement boards.

These Treasury functions are performed by an analyst (0.2 FTE) who is paid from the Pooled Investment Funds. Only 8 to 10 percent of that expense is borne by the General Fund.

Thus, the General Fund absorbs at least $61,000 (1.0 FTE accountant II) and the Pooled Investment Funds absorb approximately $11,000 (0.2 FTE analyst) in costs attributable to the retirement plans. The Finance Department submitted a 1995-96 budget reduction proposal for $61,000 to eliminate a filled accountant II position and fund those services through the retirement funds. However, the proposal was not recommended.

CONCLUSION

The Finance Department provides unreimbursed accounting services to the retirement funds. Should the City Council choose to charge the retirement funds for the cost of these activities, the General Fund would save about $61,000 per year and the Pooled Investment Funds would save about $11,000 per year.

RECOMMENDATION

We recommend that the Budget Office:

Recommendation #14:

Prepare an estimate of City expenses attributable to the Retirement Program and allocate those expenses to the retirement funds. (Priority 1)

RECEIVED
AUG 14 1995
CITY AUDITOR

CITY OF SAN JOSÉ - MEMORANDUM

TO: Gerald Silva
City Auditor

FROM: Edward F. Overton

SUBJECT: Draft Audit Report

DATE: 14 August 1995

APPROVED:

DATE:

The staff of the Retirement Office has reviewed your draft audit report of the Retirement Plan's Investment Program. While we agree with some portions of your findings and some of your recommendations, we have serious disagreements with other parts of the audit report.

It is not appropriate, in my opinion, to utilize a specific dollar amount to represent lost value in the retirement fund from not indexing. The method that was used to calculate the $73 million does not produce an accurate difference in terms of dollars between the investment results achieved by the fund and those achieved by the index. In addition, the way the $73 million was calculated would require the fund to invest 100% of their equity exposure in an index fund. A recent study by R.V. Kuhns and Associates of 93 of the largest public pension funds nation-wide representing over $39 billion does not include any funds who have 100% of their domestic equity portfolio indexed. Indexing is a viable alternative when used properly in an overall asset allocation plan. I would request that your financial audit report be modified to take out the reference to the $73 million lost value and deal with the difference in performance utilizing the percentages, which is standard for the industry.

In addition, any value difference represents only a difference at one point in time. The capital markets fluctuate in value daily and the differences between those markets and any particular portfolio change constantly. That is something that needs to be pointed out in your audit report. Also, each quarter returns that are produced by a change in market value automatically adjusts all previous quarters' returns throughout the history of the portfolio; therefore, if we were to identify the financial impact at any one point in time it would only represent a snapshot and not a permanent loss of funds.

FINDING NO. 1: OPPORTUNITIES EXIST TO INCREASE THE RETIREMENT FUNDS EARNINGS AND REDUCE INVESTMENT COSTS (1) BY ENFORCING PERFORMANCE OBJECTIVES ON THE INVESTMENT MANAGERS, (2) INCREASING USE OF PERFORMANCE-BASED FEES, (3) REDUCING THE NUMBER OF INVESTMENT MANAGERS, AND (4) INCREASING USE OF INDEX FUNDS

The Federated City Employees Retirement System and the Police and Fire Department Retirement Plan are two separate plans. They are managed by two different Boards as is pointed out in your

audit report. The Boards use different strategies to achieve their goal of sound pension plan management. The Police and Fire Plan consists of approximately $800 millions and utilizes 17 money managers, and the Federated Plan is approximately $600 million and utilizes 11 money managers. The number of money managers and the structure of the managers has changed over time. The number and structure represents the Boards' and their professional advisors' best policy decisions and is believed to be the best way to achieve the plans' objectives. The R.V. Kuhns' study shows that the average number of managers used by the nation's largest pension funds is 21. A list of the number of managers used by California plans and a list of the participants in the Kuhns' study is attached (Exhibit One).

The management structure, including the number and types, must always be designed to achieve plan goals. One such goal is to have diversity in asset classes, firm sizes, manager styles, and ethnic-gender diversity. The Boards have not sacrificed returns or increased costs beyond a reasonable level by working to achieve their stated goals.

Both plans under existing circumstances have been well administered, soundly funded and professionally monitored. The funds are making excellent progress toward their goal of accumulating assets sufficient to pay benefits in perpetuity. Both funds have an excellent funded ratio and benefits coverage ratio in comparison to other public plans in California (Exhibit Two). The Police and Fire Fund, under the Governmental Accounting Standards Board Rules, is 102% funded and the Federated Plan is 88% funded. These ratios are excellent.

The most important element of funding status is the assumptions that are adopted by the Boards and not prior investment performance. The funding status can be increased or decreased by changes in assumed interest rate, assumed salary increase rate, disability rate, and other assumptions that are utilized to fund the plans. While our funded status compares favorably to other public pension plans in California, one should not rely too heavily on the comparison without a close examination of the assumptions that are used to develop those funded status. Another way to test funded status is the annual benefits coverage ratio. Again, both funds have excellent benefit coverage ratios with the Police and Fire Plan covering benefits 34 times and the Federated asset pool covering its benefits approximately 20 times.

Both Boards utilize staff and outside advisory services to develop: investment strategy; asset allocation; investment policy; performance objectives; monitoring system manager structure; performance monitoring; and hiring and firing policy that are designed to achieve the highest risk-adjusted return given the Boards' considerations for safety and liquidity. We believe that we are making excellent progress in these areas. Achieving goals and objectives in these areas is an ongoing process and requires a series of adjustments. The Boards have made a number of adjustments over the years and will continue to do so as the situations dictate. There were numerous opportunities to produce investment returns well in excess of that which was produced by market as represented by the S&P 500. Over the ten years covered by the audit report, the S&P 500 produced a return which ranked in the 60th percentile. During this time period 60% of

the active managers produced returns that were superior to that of the S&P Index. A sample list of such managers and their returns is attached as Exhibit Three. For part of the time, we had the wrong managers, not necessarily the wrong strategy. Over the last five years the Police and Fire Plan has outperformed the S&P 500 Index. We have not employed the same money managers for ten years. In fact, if we back-tested the returns of some of the managers on Exhibit Three who now work for the Police and Fire Plan the returns for the plan would be higher. For the period ending 6/30/95, the trend of more than half of the money managers outperforming the markets continued. Attached Exhibit Four produced by Callan Investments Institute compares active styles versus a variety of benchmarks.

Defined benefit pension plans are funded on the basis of a set of assumptions that are anticipated to be achieved over a long period of time, generally 30 years or more. One key assumption is the rate of return on the assets in the plan. The assumed rate of return of both plans has generally been in the range of 8% to 8 1/2% over the last ten years. Both plans' returns have been well in excess of the assumed rate of return. The methodology that was used to develop the $73 million amount over the last ten years mixes dollar-weighted and time-weighted means of calculating returns. A time-weighted rate of return is calculated using a daily portfolio value with all cash-flow impact taken out. It is not accurate to use that rate against a portfolio whose value includes the affect of cash flow. The market value of a portfolio changes daily and the method that was used assumes a beginning portfolio value and no changes in the value of that portfolio throughout an entire year. In addition, it compounds the error by taking the difference in the values and assuming that those values were added to the portfolio and did not fluctuate in market value for an entire year. There is a percentage difference in the return of our portfolio and that of the S&P 500; however, the way that this information is presented is misleading.

Recommendation #1:

Establish probationary procedures including:

- **A process for placement on a formal watch list and subsequent probation when a manager's performance falls below applicable standards;**
- **Procedures for reporting underperformance of investment manager benchmarks on a quarterly and annual basis that calls attention to managers who are in compliance with investment performance objectives.**

We agree with Recommendation #1. We have established a policy for tracking investment manager performance. This policy was adopted by the Boards in May of 1995. The policy, shown as Exhibit Five, provides for establishing appropriate benchmarks, monitoring the managers' performance against the benchmarks, reporting performance and problems to the Boards, and taking other appropriate action to release a manager if necessary. We have also adopted a policy, shown as Exhibit Six, of tracking the adherence of managers to style and

discipline[1]. These are assignments that we have recently been able to accomplish because of significant increases in the staff that has been assigned to the retirement program. We will continue to refine these policies and procedures to keep the Boards well informed and to make necessary changes if the managers' circumstances dictate.

<u>Recommendation #2</u>:
Revise the standard language in investment manager, advisor, and custodian bank contracts, as applicable, to specify an agreed (1) management style, (2) benchmark performance standard, (3) process for dealing with underperformance, and (4) timeliness requirements for reporting, and adherence to City Council Policy 0-15.

We are in partial agreement with Recommendation #2. We have included in the most recent contracts investment styles and evaluation criteria. All investment advisor agreements will include the investment style and criteria section as they are renewed. This is something that we had determined was necessary and had taken action to achieve prior to receipt of the audit report. We have also included a section in the most recently renewed advisors' agreements that requires the manager to be aware of the City's prohibition against any gifts to City employees. It is our feeling that a process for dealing with underperformance, timeliness, reporting requirements and City Council Policy 0-15 are not appropriate items to be included in the contract. These are important areas of managing our relationship with our investment advisors; however, it is our feeling that they should be communicated to the managers outside of the actual contract. By utilizing a letter form to establish areas of performance in the above-mentioned categories we provide increased flexibility to the retirement boards in carrying out their responsibilities.

<u>Recommendation #3</u>:
Review the experience qualifications for investment managers that are specified in the San José Municipal Code and either propose changes to the Code or ensure that investment managers are in compliance.

Section 3.36.560 provides, in summary, that the plan may engage investment counselors who have been continuously engaged in the investment counseling business for not less than ten years. In our opinion, all of our investment managers meet this requirement. We do not take the more narrow view that a firm needs to have existed for ten years. If an individual has ten years of continuous experience in the investment management area then that person may establish a new firm and still qualify. It is the individual's experience that we are seeking, not necessarily the business organization.

<u>Recommendation #4:</u>
Negotiate performance-based fee structures as investment manager contracts become due.

---

[1]Such a policy has been on our needs list for several years.

We will explore the viability of performance-based fees as we renew investment contracts. We have two investment manager agreements now which contain performance-based fees. We must take care not to increase our fees unreasonably if the manager ultimately achieves the goals and objectives for which they were hired. Under performance-based fees, managers are typically paid a lower fee for not achieving goals and objectives; however, if the manager exceeds goals and objectives the fees that they receive are generally well in excess of their standard fee. Therefore, an analysis of performance-based fees should be conducted before we enter into agreements on a whole sale basis for performance-based fees.

Recommendation #5:
Reduce the number of investment managers and decrease investment fees by:

- **Increasing use of index funds;**
- **Avoiding duplicative management styles; and**
- **Pooling investments in certain asset classes between the two retirement funds.**

Index funds are a viable alternative to active management; however, we should not represent index funds as a panacea. Index funds typically perform at about the 50th percentile which means that half of the active managers beat the index and half do not. It is very easy for the fund to suffer criticism by indexing during periods when active managers are producing returns that are well in excess of that of the index.

Structuring an investment policy portfolio or investment manager pool should not be done without making an assessment of the risks that are being taken. Shown below are some selected indexes and their performances over various time periods along with the median active manager.

	3 Yrs.	5 Yrs.	10 Yrs.
S&P 500 Index	6.3	8.7	14.4
S&P Mid Cap	7.1	11.9	16.0
NASDAQ	8.7	10.6	11.8
Median Managers	6.3	8.7	14.6

As seen from the chart, various styles performed better during various time periods. So the question needs to be answered as to what index is best represented by the fund and to which one will the fund be held up against and how much risk is one assuming in an index. The funds do employ index managers and in all probability will increase the amount of assets that are under the direction of an index fund over time.

To the greatest extent possible, the funds do avoid duplicating investment manager styles. Within each style of investment management there are several different substyles. Sometimes managers look alike when in fact the securities that they are purchasing and their style of purchasing is different. The fund feels that they are achieving diversity in style when hiring managers that are

similar but not exactly alike.

The funds do pool their investment assets with one manager when they establish that it is in the best interest of the plan participants to do so. Currently, four of our investment managers are managing funds for both the plans. The Boards themselves explore options for pooling assets whenever possible. However, their interpretation of their own fiduciary responsibility dictates that this not be an automatic process.

Recommendation #6:
Establish a phased program to transfer substantial portions of the domestic equity portfolios of the two retirement plans to index managers.

The Boards are currently increasing the amount of assets that are managed by index funds. From a performance perspective, an index fund is viewed the same as an active manager. A review of Exhibit Seven shows that for the ten-year period ending December 31st, 1994, 60% of the active managers outperformed the S&P 500 index. There was substantial opportunity for the funds to increase in value well beyond the rate that the S&P 500 increased. A well-rounded investment manager pool includes growth managers, value managers, large cap managers, mid cap managers, small cap managers and index managers. It's misleading to state that by hiring an index manager one can achieve any specific dollar or percent return over any future period. Therefore, the manager line-up should be diversified. It is not accurate to represent past performance as being indicative of what one can expect in the future.

FINDING II: OPPORTUNITIES EXIST TO ENHANCE THE RETIREMENT BOARDS' ABILITY TO ASSESS THE STATUS OF THE INVESTMENT PORTFOLIO

The Retirement Boards are provided with adequate reports to allow them to assess the value of the pension plan's portfolio. They are given quarterly reports from each investment manager, a monthly summary report approved by the Director of Finance and investment transaction reports. In addition, the retirement plan portfolios are audited annually by a certified public accountant.

Over recent time periods the reporting has not been up to date. This is due primarily to hiring a new custodian bank and our attempts to automate the reporting process. As the funds have grown in asset value the ability to manually produce the investment transaction reports has diminished. Therefore we have been working with our custodian banks to automate the production of these reports to increase the accuracy and to better utilize the staff resources of the retirement program. This process has not gone as smoothly as we had hoped. Therefore, we have temporarily reverted back to manual production of the reports in order to bring the reporting current. It is still our desire to have this process automated.

Reporting on short-term investments is included in the transaction reports when short-term investments are made that are outside of the banks' short-term investment fund. It is not

necessary to report daily transactions of maturities and reinvestments in the banks' short-term investment pool. The value of those funds are reported on a daily basis to our investment managers and on a monthly basis to the Retirement Boards as part of the Finance Director's monthly financial report. Including daily transactions on the monthly investment reports would be cumbersome and provide useless information for the Retirement Boards. Their ability to set policy and direct operations of the funds would not be enhanced by that type of change.

The funds have formal asset allocation studies completed every three to five years. However, staff reviews the asset allocation plan quarterly. Asset allocation is a policy that is set by the Boards and not changed without real significant changes to the capital market structure. In addition, we regularly review our asset allocation through various industry publications with that of other similar public pension plans. In our judgment this process is adequate.

Recommendation #7:
Prepare monthly investment reports similar in scope to the Finance Department's Monthly Investment Report. The executive summary should include significant developments, market overview, portfolio mix, yields, exceptions and violations of the investment policy, description of unrealized losses and gains, comparison to budget, future commitments, and cash management projections.

The investment program for the retirement plans is a long-term process. The Boards receive quarterly reports from their investment managers, monthly transaction reports and a monthly report from the Director of Finance summarizing the status of the investment portfolio at any given month. Included in that report are gains and losses and other material information. Also included is a comparison of gains and losses from sales transactions to the prior year. Separate information is provided to the Boards on future commitments and cash management projections. Poor performance and investment policy violations are dealt with in a separate format. The Boards do not have a need to review the investment portfolio in as much detail as is done in the Finance Director's report because they employ outside consultants to provide material review in the areas that are mentioned in Recommendation #7.

Recommendation #8:
Clarify and enforce timeliness requirements for reporting by the custodian banks.

We are working with our custodian banks to increase the timeliness of reporting. Timeliness is now being hampered by attempts to increase efficiency through automating report production. We will continue to work to improve the timeliness of the banks' reporting.

Recommendation #9:
Establish a process to annually review their asset allocation strategies. This review should include a comparison to other public pension funds.

The Boards do review asset allocation as frequently as quarterly. However, they do not conduct a formal asset liability study. This process is costly and would not add value when done this frequently. The Boards are also being provided information as frequently as quarterly by their pension consultants about what other pension plans are doing in the area of asset allocation.

Recommendation #10:
Establish internal investment committees to advise the boards of administration of the retirement plans on asset allocation strategies and investment policy changes. The committees should include retirement staff, private and public sector investment experts, and City Finance Department/Administration representatives.

We do not agree with this recommendation. The Boards both employ professional. pension consulting firms with the expertise to provide the Boards with guidance in the area of asset allocation and investment policy changes. The Boards consult with their pension consultants quarterly in these areas, and they review asset allocation and liability modeling every three to five years.

Recommendation #11:
Establish a process to annually review and adopt investment policies for the respective retirement funds and distribute updated copies of the policies to invest managers and advisors annually.

We agree that the investment policy statements of the plan should be reviewed regularly, and when the policy is amended new policies should be distributed to investment advisors.

Recommendation #12:
The Federated Employees Retirement System's Board should include a liquidity statement in its investment policy. Both Boards should establish procedures requiring annual review of the cash flow requirements.

We will review the liquidity requirement as stated in the Federated Board's investment policy and make any changes that the Board and its consultant, in their best professional judgement, believe is necessary. We are now producing cash flow requirements for both funds, and this information is being provided to the Retirement Boards. Doing this in past years has been hampered by lack of staff.

Recommendation #13:
Draft an amendment to the Municipal Code for City Council approval to delete references to the City Auditor in the Municipal Code Section 2520 regarding warrants draw on the Police and Fire Fund.

We accept this recommendation.

FINDING III: CHARGING THE RETIREMENT PLANS FOR SERVICES THE FINANCE DEPARTMENT PROVIDES WOULD REDUCE GENERAL FUND EXPENDITURE BY $61,000 PER YEAR AND POOL INVESTMENT FUND EXPENSES BY $11,000 PER YEAR.

The Retirement Boards have recommended and the City Council has approved addition of certain staff members to the retirement program. If additional staffing is required in the retirement program, staff should be added to the retirement staffing level. The Boards have indicated their willingness to pay for staff that are deemed to be necessary to manage the retirement program. However, they have indicated that such staff should be under the direction of the program manager.

Recommendation #14:
Prepare an estimate of City expenses attributable to the retirement programs and allocate these expenses to the retirement funds.

We agree that the retirement program should pay the expenses of managing the program. However, those costs should be under the direct control of the individual or individuals who are responsible for managing the retirement plans.

Edward F. Overton
Retirement Administrator

EFO:daw

MAJOR CALIFORNIA PENSION FUNDS

Fund Name	Fund Size	# Managers
Contra Costa County	$1.1 billion	16
Alameda County	1.3 billion	19
Fresno County	.75 billion	13
Kern County	.59 billion	16
Los Angeles City Employees	4.0 billion	26
Los Angeles Fire & Police	5.5 billion	34
Marin County	.43 billion	7
Orange County	2.2 billion	33
CalPERS (31 Billion Fixed Inhouse)	68.0 billion	37
Sacramento County	1.0 billion	22
San BernadinoCounty	1.2 billion	19
San Diego City	1.2 billion	23
San Diego County	1.7 billion	34
San Francisco City & County	5.9 billion	33
San José Federated City Employees	.57 billion	11
San José Police & Fire	.90 billion	16
State Teachers (21 Billion Fixed Inhouse)	47.0 billion	33
Ventura County	.93 billion	11

PARTICIPANTS

Anchorage Police and Fire Retirement System
Arizona Public Safety Personnel Retirement System
Arizona State Retirement System
Firefighters Pension Fund - City of Atlanta
General Employees' Pension Fund - City of Atlanta
Police Officers Pension Fund - City of Atlanta
Austin Fire Fighters Relief and Retirement Fund
Employees' Retirement System of Baltimore
Fire and Police Retirement System of Baltimore
Baltimore County Employees' Retirement System
California Public Employees' Retirement System
California State Teachers Retirement System
Chicago Firemen's Annuity and Benefit Fund
The Retirement Board of the Policemens Annuity and Benefit Fund of Chicago
Colorado Fire and Police Pension Association
Public Employees' Retirement Association of Colorado
Contra Costa County Employees' Retirement Association
Dallas Employees Retirement Fund
Delaware State Pension Funds
Denver Employees Retirement Plan
Denver Public School Employees' Pension and Benefit Association
District of Columbia Retirement Board
Duluth Teachers' Retirement Fund Association
Employees' Retirement Fund of the City of Fort Worth
Fresno County Employees' Retirement Association
Houston Firemen's Relief and Retirement Fund
Public Employee Retirement System of Idaho
Illinois Municipal Retirement Fund
Illinois State Board of Investment
State Universities Retirement System of Illinois
Teachers' Retirement System of the State of Illinois
Indiana State Teachers' Retirement Fund
Municipal Fire and Police Retirement System of Iowa
Iowa Public Employees' Retirement System
Kansas City, Kansas Board of Public Utilities Retirement Pension Plan
Kansas City, Missouri Employees' Retirement System
Kansas City, Missouri Firefighters' Pension System
Kansas City, Missouri Police Retirement System
Kansas Public Employees Retirement System
Kentucky Retirement Systems
Kentucky Teachers' Retirement System
Kern County Employees' Retirement Association
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Los Angeles Fire and Police Pension
Marin County Employees' Retirement Association
Maryland State Retirement and Pension Systems
Milwaukee County Employees Retirement System

PARTICIPANTS

Milwaukee Employees' Retirement System
Minneapolis Teachers' Retirement Fund Association
Public Employees Retirement System of Mississippi
The Public School Retirement System of Missouri
Missouri State Employees' Retirement System
Montana Public Employees Retirement System
Montana Teachers' Retirement System
New Hampshire Retirement System
New Mexico Educational Retirement Board
New Mexico Public Employees Retirement Association
New Mexico Land Grant Permanent Fund
New Mexico State Severance Tax Fund
New York State Common Retirement Fund
New York State Teachers' Retirement System
North Dakota Public Employees Retirement System
North Dakota Teachers Fund for Retirement
The State Teachers Retirement System of Ohio
Oklahoma Firefighters Retirement System
Oklahoma Law Enforcement Retirement System
Oklahoma Police Pension and Retirement System
Oklahoma Public Employees Retirement System
Oklahoma Teacher's Retirement System
Orange County Employees Retirement System
Oregon Public Employees Retirement System
Pennsylvania Municipal Retirement System
Pennsylvania Public School Employes' Retirement System
Pennsylvania State Employes' Retirement System
Sacramento County Employees Retirement System
St. Paul Teachers' Retirement Fund Association
San Bernardino County Employees' Retirement Association
San Diego City Employees' Retirement System
San Diego County Employees Retirement Association
San Joaquin County Employee's Retirement Association
San Jose Federated City Employees Retirement System
San Jose Police and Fire Retirement Plan
San Mateo County Employees Retirement Association
Sonoma County Employees' Retirement Association
Tacoma Employes' Retirement System
Tennessee Consolidated Retirement System
Employees' Retirement System of Texas
Texas Permanent School Fund
Teacher Retirement System of Texas
Utah Retirement Systems
Ventura County Employees Retirement Association
Washington State Investment Board
Wisconsin Fixed Trust Fund
Wyoming Retirement System

Funded Status of Comparable
Public Pension Plans
6/3/92

Fund Name	Funding Status
State Teachers Retirement System	73.5%
University of California Retirement System	88.7%
Alameda County Retirement Association	74.3%
Contra Costa County Retirement System	66.7%
Fresno County Retirement Association	94.6%
Imperial County Retirement Association	75.8%
Kern County Retirement Association	77.2%
Los Angeles Retirement Association	90.3%
Marin County Employees' Retirement Association	80.2%
Mendocino County Employees' Retirement Association	68.6%
Orange County Employees' Retirement System	98.7%
Sacramento County Employees Retirement Association	74.4%
San Bernardino County Employees' Retirement Association	80.7%
San Diego County Employees' Retirement System	80.0%
City of Fresno Fire & Police Retirement System	48.2%
City of Fresno General Employees' Retirement System	78.9%
City of Los Angeles Fire & Police	55.7%
City of Los Angeles General Employees	80.1%
City of Los Angeles Water & Power	84.0%
City of Sacramento Employees Retirement System	109.0%
City of San Diego	91.5%
City of San Francisco	94.1%
City of San José Federated City Employees Retirement System	87.5%
City of San José Police & Fire Department Retirement Plan	102.6%

EXHIBIT THREE

TRAILING/CALENDAR PERFORMANCE
Domestic Equities

Manager Name: Style Name	3 Yr.	5 Yr.	10 Yr.
Alliance Capital: Large Cap Growth	6.6	11.3	17.6
Alvin F. Terry Inv.: Domestic Equity	11.4	16.4	24.8
Ark Asset Management: Large Cap Value	13.3	12.2	17.4
Arnhold/Bleichroeder: Domestic Equity	17.8	15.7	22.8
Axe-Houghton Assoc.: Growth Equities	19.6	22.2	23.7
Badgley, Phelps& Bell: Domestic Equity	2.3	8.9	17.0
Boston Co. Asset Mgt.: Value	9.6	11.7	16.9
Brinson Partners Inc.: U.S. Equity Portfolio	11.3	11.5	16.4
Capital Mgt. Corp.: Equity	8.6	13.0	16.6
Chancellor Cap Mgmt.: Select Growth Compos.	3.3	13.8	19.2
Chase Inv. Counsel: Quality Growth/Risk	4.2	13.4	17.0
Chicago Asset Mgmt.: Value/Contrarian	12.4	11.2	17.1
Coen & Densmore Inc.: Equity Management	2.4	15.0	21.6
Columbia Management: Sector Rotator	9.9	11.6	16.4
Congress Asset Mgmt: Growth	4.8	10.1	16.6
Cornerstone Asset Mg.: The Cornerstone Syst.	5.8	10.2	17.3
Crostwood Asset Mgmt: Value	10.4	10.6	17.9
Dietche & Field Adv: Value Oriented - Die	12.5	15.3	20.8
Evaluation Assoc: Domestic Equity	11.8	12.6	18.4
Executive Inv. Adv: Value	8.5	10.1	16.8
F. Martin Koenig: Equity Oriented Acco	12.0	19.9	20.8
First Madison Adv: Dynamic Style Alloca.	10.3	13.6	16.7
1st Nat'l Bank-Omaha: FNBO Value	11.2	12.5	17.7
Firstar Investment: Small Company Equity	3.4	13.5	18.0
Florence Fearrington: Value Equity	7.7	11.7	17.6
Glickenhaus & Co: Domestic Equity	13.4	12.8	16.6
Harris Associates: Equity Funds	18.7	16.3	19.1
Heine Management Grp: Equities	8.5	9.6	17.2
Husic Capital Mgmt: Growth Equity	6.5	7.8	18.7
IDS Advisory Group: Small Cap Equities	7.9	18.9	16.9
IDS-PMG: Large Cap, Growth Oriented	9.4	12.6	17.0
IDS-PMG: Core Growth Stocks	4.7	12.7	18.7
IDS-PMG: Large Cap, Growth Oriented	9.4	12.6	17.2
IDS-PMG: Core Growth Stocks	4.0	12.0	18.5
INVESCO Capital Mgmt: Value	7.5	10.0	17.0
Institutional Cap: Equity Management	10.1	12.4	19.5
Invesco Trust Co: Equity Growth	5.7	13.8	18.3
Investment Research: Large Cap Core Equity	8.2	10.4	17.8
Kunath Karren Rinne: Growth	16.2	15.3	17.0
Loomis, Sayles: Relative Value	14.8	13.6	16.6
Lynch & Mayer: Large Cap Growth Equity	3.6	12.7	18.4

EXHIBIT TWO

Manager Name: Style Name	3 Yr.	5 Yr.	10 Yr.
Meridian Capital: Mid Cap Value	11.8	12.8	17.6
NBD Bank, N.A.: Opportunity	16.3	14.2	16.5
Neuberger & Berman: Medium to Large Cap	9.1	11.1	16.5
Neuberger & Berman: Small Capitalization	9.4	12.5	18.7
PROFITEK, Inc: Exclusivel Small Cap	18.2	17.6	19.0
Peregrine Capital Mgmt: Small Cap Equities	13.8	22.6	22.1
Provdent Inv. Couns: Growth Equity	3.5	17.2	19.9
Scudder, Stevens: Growth & Income	9.3	11.5	17.1
Shawmut Inv. Adv. Inc: Small Cap Equity	9.5	11.7	18.0
Simms Capital Mgmt: Global Equities	6.4	15.6	20.5
Sirach Capital Mgmt: Equity	4.2	11.6	17.2
Southeastern Asset: Equity Value	16.5	12.3	16.7
State Street Global: Matrix Equity	7.7	11.1	17.9
Talon Asset Mgmt: Equity	7.3	12.4	21.0
Target Investment Inc: Smaller Cap/Agressive	11.3	17.6	17.9
Trend Capital Mgmt: Style Identification	12.2	15.1	18.0
TSB&J: Top Down Growth	5.9	9.4	16.9
Trust Fund Advisors: Growth Equity	12.1	17.9	20.8
Tukman Capital Mgmt: Domestic Equity	6.1	12.9	18.7
Vector Money Mgmt: Domestic Equity	8.5	9.5	16.9
Waddell & Reed: Agressive Equity	11.8	11.3	17.1
Wasatch Advisors Inc: Small Cap Growth	10.3	17.5	16.7
Wellington Mgmt Co: Contrary Sector Alloc.	11.2	10.4	16.6
Wertheim Schroder: Relative Value Equity	10.3	9.2	16.5
Yacktman Asset Mgmt: Bottom Up Value	5.3	12.4	17.0

Index Comparisons	3 Yr.	5 Yr.	10 Yr.
S&P 500	6.3	8.7	14.4
Wilshire Large Cap Growth	2.8	9.8	14.9
Wilshire Large Cap Value	7.5	7.6	13.8
S&P Mid Cap 400	7.1	11.9	16.0
Wilshire Next 1750 Small Cap	11.2	10.3	12.8
Wilshire Small Cap Growth	10.3	11.3	11.9
Wilshire Small Cap Value	13.1	11.7	15.8

CALLAN INVESTMENTS INSTITUTE
Active Manager Performance vs. The Market

Callan Associates Inc. has conducted a survey of its investment manager database in order to determine how many equity and fixed-income managers have provided performance in excess of their respective benchmarks. The database contains performance results from major money managers, including investment counselors, insurance companies, and banks. The results are summarized in the table below.

	PERIODS ENDING 6/30/95				
EQUITY	**One Quarter**	**One Year**	**Three Years**	**Five Years**	**Ten Years**
Domestic Managers					
Total Equity Median	8.78	22.68	14.19	12.95	14.74
Percent of Managers Outperforming S&P 500	36%	29%	63%	68%	51%
Annualized Total Return S&P 500	9.53	26.08	13.18	12.05	14.65
International Managers					
Total Equity Median	2.89	1.75	11.29	6.42	17.38
Percent of Managers Outperforming MSCI EAFE	84%	51%	29%	69%	81%
Annualized Total Return MSCI EAFE	0.73	1.66	12.68	4.69	16.04
FIXED					
Domestic Managers					
Total Fixed Median	5.68	11.64	7.61	9.62	10.01
Percent of Managers Outperforming LB Aggregate	38%	32%	54%	58%	50%
Total Annualized Return LB Aggregate Index	6.09	12.54	7.48	9.40	10.01
International Managers					
Total Fixed Median	4.51	18.62	12.69	14.88	17.07
Percent of Managers Outperforming Salomon Non-U.S.	30%	3%	10%	33%	80%
Annualized Return Salomon Non-U.S. Government Bd.	4.89	22.71	13.81	15.57	16.22

CALLAN ASSOCIATES INC.
SUMMARY OF TIME-WEIGHTED RATES OF RETURN
CUMULATIVE PERIODS ENDED JUNE 30, 1995

EQUITY COMPARISONS

Annual Rates of Return

	One Quarter	One Year	Three Years	Five Years	Ten Years
MARKET INDICATORS					
Standard & Poor's 500	9.53	26.08	13.18	12.05	14.65
Dow Jones Industrials	10.28	29.12	14.35	12.99	16.91
Callan Broad Market Index	9.22	24.77	12.99	12.07	13.99
Callan Large Cap Index	10.20	27.08	11.87	11.09	14.23
Callan Medium Cap Index	7.84	21.90	13.81	13.21	14.09
Callan Small Cap Index	8.40	22.57	15.85	13.98	13.42
Consumer Price Index	0.80	3.08	2.76	3.16	3.43
MANAGER CATEGORY					
25th Centile					
TOTAL EQUITY DATABASE	10.27	26.71	17.16	15.22	15.98
Growth & Income Mutual Funds	9.20	21.85	13.37	12.17	13.68
Growth Mutual Funds	11.09	26.44	14.91	13.14	14.44
TOTAL BALANCED DATABASE	8.29	19.59	12.19	12.23	13.55
Median (50th Centile)					
TOTAL EQUITY DATABASE	8.78	22.68	14.19	12.95	14.74
Growth & Income Mutual Funds	8.05	19.87	11.83	11.03	12.67
Growth Mutual Funds	9.04	22.32	12.55	11.02	13.02
TOTAL BALANCED DATABASE	7.40	17.35	10.75	11.29	12.75
75th Centile					
TOTAL EQUITY DATABASE	7.12	19.08	12.25	11.57	13.49
Growth & Income Mutual Funds	7.00	17.26	10.10	9.89	11.35
Growth Mutual Funds	7.25	18.43	9.61	9.45	11.62
TOTAL BALANCED DATABASE	6.54	15.59	9.68	10.24	11.86

CALLAN ASSOCIATES INC.
SUMMARY OF TIME-WEIGHTED RATES OF RETURN
CUMULATIVE PERIODS ENDED JUNE 30, 1995

FIXED-INCOME COMPARISONS

Annual Rates of Return

	One Quarter	One Year	Three Years	Five Years	Ten Years
MARKET INDICATORS					
Salomon High Grade Bond Index	9.02	17.66	9.69	11.26	11.82
Lehman Brothers Aggregate	6.09	12.54	7.48	9.40	10.01
Treasury Bills	1.42	5.44	3.99	4.72	5.95
Consumer Price Index	0.80	3.08	2.76	3.16	3.43
MANAGER CATEGORY					
25th Centile					
TOTAL FIXED-INCOME DATABASE	6.48	12.83	8.37	10.31	10.65
Median (50th Centile)					
TOTAL FIXED-INCOME DATABASE	5.68	11.64	7.61	9.62	10.01
75th Centile					
TOTAL FIXED-INCOME DATABASE	4.60	9.78	6.67	8.84	9.37

PROCEDURES MANUAL
RETIREMENT OFFICE

SECTION TITLE: **PROCEDURE FOR TRACKING MANAGER PERFORMANCE**	SECTION NO. 450	PAGE 1 OF 2 EFFECTIVE: DATE
APPROVED		DATE 5/9/95

PURPOSE

To provide guidelines for reacting to manager poor performance.

POLICY

It is the policy of the Retirement Board to monitor the portfolio of the Federated Plan for prudent adherence to approved performance guidelines. The Board, staff, and its consultant shall have primary responsibility for tracking performance.

The Board approved investment policy states that investment managers are expected to perform within the top half of an appropriate broad database, rank in the top half of a similarly styled managers, and earn an average annual return which exceeds an appropriate index. These minimum performance standards are to be achieved over a rolling five year time period or a full market cycle.

PROCEDURES

RESPONSIBILITY	ACTION
Pension Consultant	Establish appropriate benchmarks and disciplines for managers, and get manager approval for those benchmarks.
Staff	Inform managers of benchmark selections and request Pension consultant to report manager performance against those and other investment policy criteria.
Pension Consultant	Figure and analyze the performance of managers against policy guidelines and report it to the Board on a quarterly basis including annualized data.
Staff, Pension Consultant	YEARLY: Inform Board of managers who are not meeting performance criteria, and research possible explanations for such performance.

Staff, Pension Consultant	AS NEEDED: Inform Board of managers who should be terminated or placed on probation in light of other criteria such as changes in ownership structure, changes in key personnel, changes in portfolio characteristics, deviation from investment style, new business lines, and declines or increases in business.
Board	Using Staff or Pension Consultant reports, make decision about managers.
Board	If performance remains below indices at two or three year marks, have staff review losses generated by the manager's performance to determine if replacement costs are justified.
Staff	AS REQUESTED: Determine the cost of replacing various types of managers based on cost of managers search and size of portfolio. Manager yield as it is reported by the consultants can be used to determine the cost of an individual manager's under performance compared to their benchmark.
Board	Take steps to terminate the manager if the loss of funds approaches the cost of replacing the manager or is a certain percentage thereof for a market cycle, one, or three years annualized.
Staff	If a manager is placed on probation, inform them that they shouldn't make drastic changes from their proscribed styles or in the portfolio make-up because high portfolio turnover is expensive.
Board	If organizational changes such as a style drift or portfolio characteristics are affecting a manager's performance, review the effect on the portfolio and decide if it is desirable for the total portfolio. If it isn't, the manager should be terminated. If it is desirable, the indices should be changed accordingly to match their new style. "Due diligence" dictates that the Board reinvestigate a firm that has experienced a significant change in ownership structure or personnel before any change in performance is noticed.

PROCEDURES MANUAL
RETIREMENT OFFICE

SECTION TITLE: **PROCEDURE FOR TRACKING MANAGER PERFORMANCE THROUGH ADHERENCE TO STYLE AND DISCIPLINE**	SECTION NO. 460	PAGE 1 OF 1 EFFECTIVE: DATE
APPROVED		DATE 5/9/95

PURPOSE

To provide guidelines for tracking manager style and discipline.

POLICY

As a part of the Retirement Board's policy to monitor the portfolio of the Federated Plan for prudent adherence to approved performance guidelines, the staff and consultant will have primary responsibility for periodically monitoring the manager holdings to ensure they are adhering to expected investment styles and disciplines.

PROCEDURES

RESPONSIBILITY	ACTION
Pension Consultant, Staff	Establish appropriate manager style or discipline profiles, including sell disciplines, and get manager approval for those profiles.
Staff	Establish definitions of the various styles and disciplines and come to an understanding of what types of stocks fit those definitions.
Staff	Periodically review the manager portfolio holdings and recent transactions to see if they are adhering to their investment style.
Staff	Communicate with Manager who are straying from their discipline, and solicit explanations for the changes in portfolio characteristics.
Staff	Inform Board of managers who are deviating from their investment style or sell discipline, and give a recommendation as to whether or not they should be terminated, placed on probation, or encouraged.
Board	If style drift or portfolio characteristics are affecting a manager's performance, review the effect on the portfolio and decide if it is desirable for the total portfolio. If it isn't, the manager should be terminated. If it is desirable, their portfolio profile and indices should be changed accordingly to match their new style.
Staff	If a manager is placed on probation, inform them that they shouldn't make drastic changes from their proscribed styles or in the portfolio make-up because high portfolio turnover is expensive.

ina
Return/Risk vs S&P 500 (10 Year)
Domestic Equity

Mobius Broad Equity

	Return	Std Dev	Sharpe Ratio	Up Ratio	Down Ratio	# of Neg Quarters	Worst Quarter	Worst 4 Quarters	Worst Return
BEST	31.4	4.8	1.5	237	-172	4	-1.6	6.4	-1.8
5th	20.1	11.5	0.8	133	47	7	-12.0	-4.6	-12.7
10th	18.0	12.8	0.7	122	62	8	-15.0	-7.0	-15.1
20th	16.6	14.2	0.6	112	76	9	-17.3	-9.4	-17.6
25th	16.2	14.7	0.6	109	80	9	-18.3	-10.1	-18.5
30th	15.9	15.1	0.6	107	84	10	-19.0	-11.0	-19.2
40th	15.4	15.8	0.6	104	90	10	-20.1	-12.1	-20.4
50th	14.8	16.3	0.5	100	95	11	-21.3	-13.4	-21.5
60th	14.4	17.0	0.5	98	100	11	-22.2	-15.0	-22.4
70th	13.8	18.0	0.5	94	106	12	-23.1	-16.8	-23.3
75th	13.6	18.7	0.5	92	109	12	-23.6	-17.6	-23.9
80th	13.3	19.4	0.4	89	113	13	-24.3	-18.7	-24.7
90th	12.2	21.6	0.4	82	124	13	-26.4	-22.3	-27.1
95th	11.4	24.4	0.3	74	135	14	-28.3	-25.8	-29.1
WORST	-1.6	62.0	-1.5	-15	183	19	-43.3	-49.1	-53.7

Universe Statistics	Firms	Styles
Number Included :	942	2,174
Distinct Styles :	N/A	1,535
Assets Reported :	$3,246,101,000,000	$1,091,123,000,000
Number Reporting Assets :	724	1,200
Percent Reporting Assets:	76.9	78.2
Implied Assets :	$4,223,518,151,934	$1,395,728,170,833

OFFICE OF THE CITY AUDITOR'S COMMENTS ON THE RESPONSE OF THE RETIREMENT OFFICE TO AN AUDIT OF THE CITY OF SAN JOSE'S RETIREMENT PLANS' INVESTMENT PROGRAM

The following comments are presented to respond to statements in the response of the Retirement Office to *An Audit Of The City Of San Jose's Retirement Plans' Investment Program.*

Retirement Office Response - Page 1, Second Paragraph 2

> *It is not appropriate, in my opinion, to utilize a specific dollar amount to represent lost value in the retirement fund from not indexing.... In addition, the way the $73 million was calculated would require the fund to invest 100% of their equity exposure in an index fund.... I would request that your financial audit report be modified to take out the reference to the $73 million lost value and deal with the difference in performance utilizing the percentages, which is standard for the industry.*

Auditor's Comments

The percentage comparison noted above is shown in Table 9 on page 25 of the audit report. That comparison shows that both retirement funds' domestic equity portfolios underperformed the annualized rate of return of the S&P 500 for the ten-year period from 1984-85 to 1993-94. Specifically, the Federated Fund portfolio's annualized rate of return was 11.7 percent, the Police and Fire Fund portfolio's annualized rate of return was 14 percent, and the S&P 500's annualized rate of return was 15.1 percent. To an economist that comparison, in and of itself, proves that the equity managers the two retirement funds used did not add value to the portfolios.

While these percentage comparisons are important and were included in the audit report, in our opinion, it is also critical to convert those percentage comparisons to a more easily understood common denominator--dollars. Specifically, the calculation of the $73 million in Table 19 on page 49 translates the effect of small percentage differences in percentage yields into dollar terms the average lay person can understand. Further, converting rates of return to dollars is a common practice. For example, a recent San Jose Mercury article on mutual fund investing pointed out the difference that a one percent change in yield could make.

Consider one calculation by Gerald Perritt, editor of the Chicago-based Mutual Fund Letter. An investment of $10,000 returning 12 percent a year grows to $96,463 after 20 years, he notes. But say, instead, that $10,000 returns 11 percent. Then the nest egg grows to $82,639 -- or $14,094 less.

"There's a moral here," Perritt says. "Little mistakes cost plenty."

Finally, as stated on page 21 of the report, *"if the retirement plans' equity portfolios had been invested in an equity index fund instead of with the variety of managers that were used, we estimate that the portfolios could have earned an additional $72.8 million over the last ten years and saved about $10 million in management fees paid to equity managers."* [Emphasis added.] In fact, this estimate of underperformance is conservative because it assumes 100 percent of the portfolio earning the S&P 500 yield. For example, if the fund was 80 percent invested in an index fund and 20 percent with managers producing investment returns in excess of the index, the difference in earnings would have been greater than the $73 million we estimated in our audit report. Moreover, if the equity managers had achieved their stated goal of outperforming the S&P 500, the difference in earnings would have been even greater still.

Retirement Office Response - Page 1, Third Paragraph

In addition, any value difference represents only a difference at one point in time. . . . That is something that needs to be pointed out in your audit report.

Auditor's Comments

See page 25 of the report in the section entitled *"Results Vary From One Period To The Next."*

Retirement Office Response - Page 2, First Paragraph

The R.V. Kuhns' study shows that the average number of managers used by the nation's largest pension funds is 21. A list of the number of managers used by California plans and a list of the participants in the Kuhns' study is attached (Exhibit One).

Auditor's Comments

Exhibit One shows that several California plans use from 11 to 16 managers. However, a closer review of Exhibit One shows that all but one of those plans have a higher average manager portfolio size than San Jose's plans.

	Fund Size (in millions)	Number of Managers	Average Manager Portfolio Size (in millions)
Ventura	930	11	85
Contra Costa County	1,100	16	69
Fresno County	750	13	58
San Jose Police & Fire	**900**	**16**	**56**
San Jose Federated	**570**	**11**	**52**
Kern County	590	16	37

As stated on pages 42 through 43 of the audit report, the proliferation of investment managers creates a tremendous amount of work for staff, increases the costs of investment advisors, and results in proportionately higher fees.

Retirement Office Response - Page 3, First Paragraph

For part of the time, we had the wrong managers, not necessarily the wrong strategy. Over the last five years the Police and Fire Plan has outperformed the S&P 500 Index.

Auditor's Comments

As shown in Table 19 on page 49 of the audit report, the Police and Fire Fund underperformed the S&P 500 in seven out of the last ten years. Table 11 on page 28 of the audit report shows that as of December 31, 1994, **none of the eight equity managers reporting** (the consultant did not provide rankings for two equity managers) ranked in the top third--the investment policy's specified minimum performance ranking. Table 13 on page 30 shows that only one out of six reported equity managers beat the S&P 500 for the previous 12 months. This poor performance is why we have made a series of recommendations concerning establishing probationary procedures and reporting underperformance, revising contracts, reviewing experience qualifications, and negotiating performance-based fee structures.

As the recent book, Bogle on Mutual Funds, by John C. Bogle states,

> *At this point you may be asking: "Isn't there a better answer to the question of predicting, at least implicitly, the future relative performance of the fund chosen? Isn't there an alternative to moving from one fund to another as hope about a fund's strategy or its implementation by the fund's investment adviser turns to disappointment, and then again from disappointment to hope as the shares of the first fund are redeemed and the second purchased?" Speaking of this phenomenon among corporate pension funds, James Vertin, a pioneer in capital market theory, put it this way:*
>
> > *After twenty years of watching investment practitioners dance around the fire shaking their feathered sticks, I observe that far too many of their patients die and that the turnover of medicine men is rather high. There must be a better way.*
>
> *He concluded, "And there is!"*
>
> *What there is, of course, is the index fund. Simply put, an index mutual fund is a fund that owns a full participation in some particular segment of the financial market. By far the most common variety of index fund--and the one with the longest history behind it--is a fund that replicates the Standard & Poor's 500 Composite Stock Price Index. This index is heavily weighted by the stocks with the largest market capitalizations . . . and historically has represented about 70% of the value of all U.S. common stocks.* [Emphasis added.]

As stated on pages 45-47 of the audit report, this methodology--indexing--has been adopted by a growing number of pension plans across the country. Both PERS and STRS invest 80 percent of their equity portfolios in the broad market index.

Retirement Office Response - Page 3, Second Paragraph

> *The market value of a portfolio changes daily and the method that was used assumes a beginning portfolio value and no changes in the value of that portfolio throughout an entire year. In addition, it compounds the error by taking the difference in the values and assuming that those values were added to the portfolio and did not fluctuate in market value for an entire year. There is a percentage difference in the return of our portfolio and that of the S&P 500; however, the way that this information is presented is misleading.*

Auditor's Comments

As stated above, the purpose of the $73 million comparison is to show the magnitude of the underperformance of the City's equity portfolio managers as compared to the S&P 500. We rounded our estimates so as not to imply a level of exactness that we did not intend to achieve. In using the portfolio value at the beginning of each year we may, in fact, be understating the average value of the portfolio during the year, since contributions were being added to the funds during the year. In addition, in estimating the cumulative cost to the retirement funds, we assumed that the foregone earnings in the previous year were reinvested at the beginning of the subsequent year (not during the course of the prior year). Finally, it should be noted that the $73 million only compares the funds' performance to the S&P 500 in spite of the fact that the retirement boards' strategy was to beat the S&P 500 and outperform the majority of domestic equity managers.

Retirement Office Response-Page 4, Third Paragraph

> *We are in partial agreement with recommendation #2. . . . It is our feeling that a process for dealing with underperformance, timeliness, reporting requirements and City Council Policy 0-15 are not appropriate items to be included in the contract.*

Auditor's Comments

In view of the extensive problems that we found with investment managers' underperformance (as documented in Finding 1 of the audit report) and lack of timely reporting on the part of custodian banks (as documented in Finding 2), this recommendation should be implemented. Further, referring to the City Council's code of ethics policy in a contract with a manager who has a fiduciary responsibility for millions of City, employee, and retiree dollars is a reasonable and prudent procedure. Finally, we believe the boards should supplement any contract language with additional periodic communications in a letter form as policies change or other issues emerge.

Retirement Office Response-Page 6, Fourth Paragraph

> *A review of Exhibit Seven shows that for the ten-year period ending December 31st, 1994, 60% of the active managers outperformed the S&P 500 index. There was substantial opportunity for the funds to increase in value well beyond the rate that the S&P 500 increased.*

Auditor's Comments

The problem that we have documented in our report is that both retirement funds' equity portfolios have dramatically underperformed the broad equity markets over the past ten years. Secondly, both retirement funds paid over $10 million in management fees to achieve that result. Obviously, picking better performing managers and enforcing performance standards on them in the future is a critical component of future earnings.

Further, adjusting the figures in Exhibit Seven for the difference in active versus index management fees (commissions) reveals that 50 percent of active equity portfolio managers outperformed their indexed counterparts while 50 percent underperformed their indexed counterparts. This is consistent with modern portfolio theory which states that

1. *Since all investors collectively own the entire stock market, if passive investors--holding all stocks, forever--can match the gross return of the stock market, then active investors, as a group can do no better. They too must match the gross return of the stock market.*
2. *Since the management fees and transaction costs incurred by passive investors are substantially lower than those incurred by active investors, and both provide equal gross returns, then passive investors must earn the higher net returns.* [Source: Bogle on Mutual Funds]

Transferring a substantial portion of the funds' equity portfolios to index management would ensure that those portions of the portfolio earn the market rate of return. This does not close the door on other potential equity investments that the boards or their advisors believe will outperform the broad market rate of return.

It should also be noted that throughout this report we have used the S&P 500 as an index management standard. There are several other indexes currently in use by index managers that capture broad market performance. A widely used index of the broad market is the Wilshire 5000 Index which includes the 500 stocks in the S&P 500 plus 4,500 additional domestic stocks that are actively traded; PERS uses the Wilshire 2500 Index.

APPENDIX A

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Administration Manual (CAM) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class[1]	Description	Implementation Category	Implementation Action[3]
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.[2]	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists.[2]	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

---

1 The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. (CAM 196.4)

2 For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of $25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of $50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens. (CAM 196.4)

3 The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration. (CAM 196.4)

City of San Jose, California

COUNCIL POLICY

TITLE	PAGE	POLICY NUMBER
CODE OF ETHICS FOR OFFICIALS AND EMPLOYEES OF THE CITY OF SAN JOSE	1 OF 5	0-15
	EFFECTIVE DATE 08/19/80	REVISED DATE 06/25/91

APPROVED BY

Council Action: April 3, 1964-Resolution No. 25527 (rescinded 10/14/80)
March 11, 1980
August 19, 1980-Resolution No. 53699 (rescinded 10/14/80)
October 14, 1980-Resolution No. 53971
March 23, 1982-Resolution No. 55371
June 25, 1991-Item 9j, Resolution No. 63171

Purpose and Scope: To establish policy and guidelines for use by and applicable to elected and appointed City officials, City officers, including Board and Commission members, and Civil Service employees in the discharge of their officially assigned duties and responsibilities. Individuals employed by the City under contractual agreement must also observe the provisions of this policy statement for the term of their contract or otherwise as the contract may stipulate.

Declaration of Policy: Elected and appointed officials and employees of the City of San Jose (hereinafter "City") at all levels are agents of the public purpose and conservators of the public trust. The proper operation of municipal government requires that they be independent, impartial and responsible in the fulfillment of the public trust placed on them. The citizens of San Jose expect and must receive the highest standard of ethics from all those in public service, regardless of personal consideration.

Responsibilities of Public Service: Persons in the public service are bound to uphold the Constitution of the United States and the Constitution of the State of California and to carry out the laws of the nation, state, and the City. They are bound to observe, in their official acts, the highest standards of integrity and to discharge faithfully the duties of their offices, recognizing that the lives, safety, health and welfare of the general public must be their primary concern. Their conduct in both their official and private affairs should be above reproach to assure that their public office is not used for personal gain.

General Rule with Respect to Conflicts of Interest: The State Political Reform Act of 1974 prohibits all City officials, officers and employees from making, participation in making, or attempting in any way to use his or her official position to influence a governmental decision in which the employee knows or has reason to know he or she has a financial interest.

Persons in the public service shall not make personal investments nor maintain any direct or indirect interest in enterprises, activities, or entities which they have or ought to have reason to believe may be involved in decisions or recommendations to be made by them or persons under their supervision, or which may otherwise create a substantial conflict between their private interests or may impair their independence of judgment in the discharge of their official duties. If, however, persons in the public service have financial interests in matters coming before them, or before the department in which they are employed, they shall disqualify themselves from making, participating in the making, or seeking to influence any decision respecting such matter.

TITLE	PAGE	POLICY NUMBER
CODE OF ETHICS FOR OFFICIALS/EMPLOYEES OF SAN JOSE	2 OF 5	0-15

Acceptance of Favors and Gratuities: Persons in the public service shall not accept money or other consideration or favors from anyone other than the City for the performance of an act which they would be required or expected to perform in the regular course of their duties; nor shall such persons accept any gifts, gratuities or favors of any kind which might reasonably be interpreted as an attempt to influence their actions with respect to City business.

For purposes of this Policy, the term "gift" is used as defined in Municipal Code Chapter 10.36 and all exceptions in that Chapter also apply to this Policy except where otherwise provided in a more stringent departmental or administrative policy. Employees are advised to check with their departments for such a policy. The exceptions in Chapter 10.36, Section 10.36.380 are included below.

Gifts which are acceptable are as follows:

A. Gifts Less than $15

Token gifts which have a value of no more than Fifteen Dollars ($15.00), as long as the total value of all such token gifts received from any one donor do not exceed Fifteen Dollars ($15.00) in any calendar year.

B. Informational Material

Informational material such as books, reports, pamphlets, calendars, or periodicals or reimbursement for any such expenses. Informational material does not include provision of educational trips including transportation, accommodation and food.

C. Hospitality

Gifts of hospitality involving food, beverages or lodging provided to any officer or employee by an individual in such individual's primary residence.

D. Reciprocal Gifts

Gifts exchanged between any officer or employee and an individual other than a local governmental lobbyist on holidays, birthdays, or similar occasions. This exception shall not apply to the extent that the gift received by the officer or designated employee exceeds in value gifts that he or she has given to the donor.

E. Meals and Beverages

Meals and beverages provided to an officer or employee in a business or a social setting.

TITLE	PAGE	POLICY NUMBER
CODE OF ETHICS FOR OFFICIALS/EMPLOYEES OF SAN JOSE	3 OF 5	0-15

F. Honoraria and Awards

Honoraria and awards. As used in this Chapter, "honorarium" means a payment or gift for speaking at an event, participating in a panel or seminar, or engaging in any similar activity.

G. Panels and Seminars

Free admission, food, beverages, and similar nominal benefits provided to an officer or employee at an event at which the officer or employee speaks, participates in a panel or seminar or performs a similar service, and reimbursement or advance for actual intrastate travel or for necessary accommodations provided directly in connection with such event.

H. Admission Given by Sponsor of an Event:

Admission to ceremonial, political, civic, cultural or community functions provided by a sponsor of the event for the personal use of the officer or employee.

I. Employment Interview - Government Employer

Transportation, accommodation, food and directly related expenses advanced or reimbursed by a governmental agency in connection with an employment interview, when the interview is conducted at least 150 miles from San Jose and where the situs of the employment will be at least the same distance from the City.

J. Employment Interview - Private Employer

Transportation, accommodation, food and directly related expenses incurred in connection with an employment interview and a bonafide prospect of employment, when the expenses are advanced or reimbursed to an officer or employee by a potential employer, provided that the officer or employee has not made or participated in the making of a governmental decision materially affecting the financial interest of the potential employer during the twelve (12) months immediately preceding the time the expenses are incurred or the offer of employment is made, whichever is sooner.

K. Authorized Travel

Transportation, accommodation, food and directly related expenses for any officer or employee which has been authorized by a majority of the Council or Agency board or which is pursuant to a written City or Agency policy for intrastate or interstate travel regardless of the source of payment.

L. City or Agency Business

Transportation provided to an officer or employee by a contractor or other person doing business with the City or Redevelopment Agency, provided that such transportation is related to City or Agency business which is within the scope of employment or the duties of such officer or employee, and further provided that such transportation is not in excess of 125 miles one way. Nothing of this Subsection shall be interpreted to limit the Council's or Agency Board's discretion to approve travel under Subsection K above.

M. Flowers

Flowers, plants or balloons which are given on ceremonial occasions, to express condolences or congratulations, or to commemorate special occasions.

N. Prizes

A prize awarded on the basis of chance, provided that there are at least one thousand (1,000) participants eligible to win the prize, a majority of whom are not public officials or government employees.

Section 10.36.360 also provides that prohibited gifts do not include any rebate or discount in the price of anything of value which is made in the regular course of business to members of the public without regard to official status or a rebate or discount which is made available to all officers and employees of the City and Redevelopment Agency on an equal basis. Further, campaign contributions which comply with the Municipal Code and Political Reform Act of 1974 as amended and any devise or inheritance are not prohibited gifts under Chapter 10.36 of the Municipal Code.

Use of Confidential Information: Persons in the public service shall not use confidential information acquired by or available to them in the course of their employment with the City for speculation or personal gain. Persons in the public service shall uphold the public's right to know, and in accordance with the Brown Act, uphold the public's right to know not only the decisions taken, but also the deliberations which shape public policies.

Use of City Employment and Facilities for Private Gain: Persons in the public service shall not use, for private gain or advantage, their City time or the City's facilities, equipment or supplies, nor shall they use or attempt to use their position to secure unwarranted privileges or exemptions for themselves or others.

Incompatible Employment: Persons in the public service shall not engage in or accept private employment or render services for private interests when such employment or service is incompatible with the proper discharge of their official duties or would tend to impair their independence of judgment or action in the performance of their official duties. All City employees considering outside

employment must apply for an Outside Work Permit prior to acceptance of the employment offer. It shall be the Administration's responsibility to determine if the outside work is compatible in accordance with Section 3.04.1710 of the San Jose Municipal Code.

Discussion of Future Employment: All offers or discussions of offers to City employees of future employment outside the City service must be reported immediately to the employee's supervisor whenever such discussions occur with, or when such offer is made by, any person, firm or organization presently dealing with the City concerning matters directly within the employee's current areas of decision-making responsibilities. It shall be within the supervisor's discretionary powers to relieve said employee from further decision-making responsibilities in relationship to said person, firm or organization if he or she determines that the offer of employment or discussions of an offer of employment would impair the employee's independence of judgment or could be construed by others as a bid for favorable treatment.

Activities Incompatible with Official Duties and the Reporting of Improper Government Activities: Persons in the City service are strongly encouraged to fulfill their own moral obligations to the City by disclosing to the extent not expressly prohibited by law, improper governmental activities within their knowledge. No officer or employee of the City shall directly or indirectly use or attempt to use the authority or influence of such officer or employee for the purpose of intimidating, threatening, coercing, commanding, or influencing any person with the intent of interfering with that person's duty to disclose such improper activity.

Affirmative Action: Persons in the public service shall not, in the performance of their service responsibilities, discriminate against any person on the basis of race, religion, color, creed, age, marital status, national origin, ancestry, sex, sexual preference, medical condition, or handicap and they shall comply with the equal employment opportunity and affirmative action goals and objects of the City.

Penalties for Non-Compliance: In addition to any other penalty as provided by law, violations of this Code of Ethics may be used as a basis for disciplinary action or censure of a Council Member by the Council. Violations of this Code of Ethics by Board and Commission Members shall constitute official misconduct.